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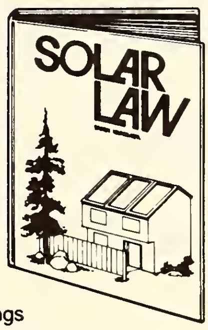

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Sandy F. Kraemer is a Colorado Springs (Colorado) lawyer whose combined background in engineering and law has been channeled in support of new legal concepts to encourage solar energy development.

Author of many articles on solar law, he has sponsored relative state legislation and local ordinances. He is sought as a legal counselor by solar industries, is a nationally recognized speaker on energy policy and solar law. He serves as a consultant to the Phoenix Solar Project which is supported by the National Science Foundation.

Kraemer received his B.S. from Stanford University and J.D. from the University of Colorado for which he presently serves as a member of the Board of Regents.

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Articles

Comment

Notes

Book Review

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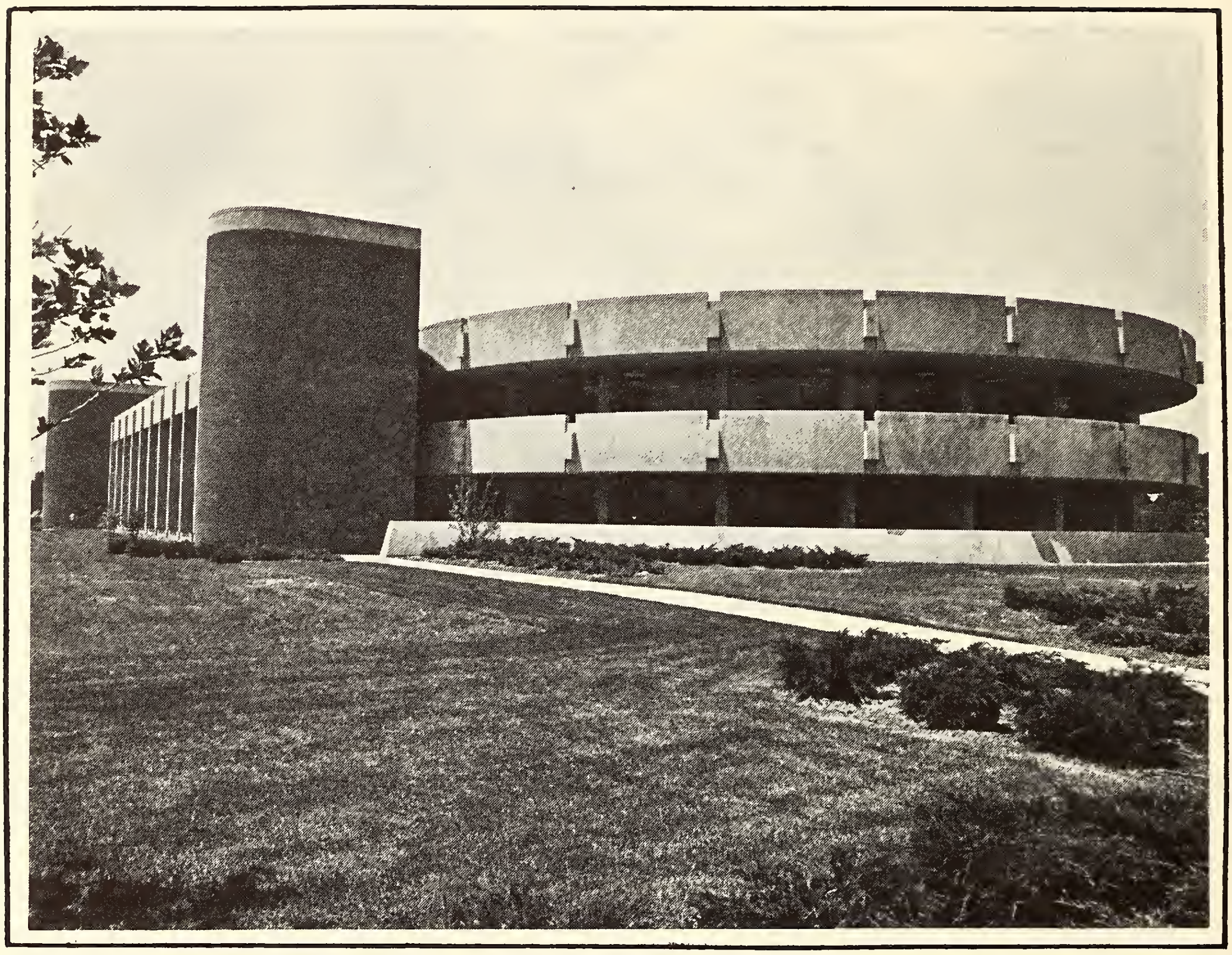

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Volume 13 | 1980 | Number 2

Reexamining the Relationship Between Capital Gain and the Assignment of Income

*David F. Shores**

I. Introduction

Only gain from the sale or exchange of property qualifies for preferential capital gain treatment under the Internal Revenue Code (IRC).[1] When an interest is sold the question sometimes arises whether the interest is a property interest qualifying for capital gain treatment, or an income interest which is not a capital asset because it is not "property" within the meaning of section 1221 of the Code. The property versus income distinction is also crucial to the assignment of income doctrine, which states that only property, not income, can be transferred by gift for income tax purposes.[2] If an interest believed to be a property interest is transferred by gift and is later found to be an income interest, the transfer will be disregarded for tax purposes and the transferor taxed on the income. For example, a fee owner of real estate might give his child the right to collect rent from the real estate for a five-year period. Although the child may have an enforceable right to the rent under local law, the assignment of income doctrine precludes recognition of the transfer and therefore the donor will be taxed on the income. If,

*Professor of Law, Wake Forest University School of Law. B.B.A. University of Iowa, 1965; J.D., University of Iowa, 1967; L.L.M., Georgetown Law Center, 1969.

[1]I.R.C. §§ 1221, 1222. *See also id.* §§ 1201-1202, 1221-1222.

[2]*Compare* Blair v. Commissioner, 300 U.S. 5 (1937) (life estate in trust may be assigned by gift), *with* Helvering v. Horst, 311 U.S. 112 (1940) (interest coupons detached from bonds cannot be assigned by gift). Under the grantor trust rules, an income interest of 10 years or more may be assigned through a 10-year trust and the donee will be taxed on the income. I.R.C. §§ 671-677. A mere right to income, however, cannot be assigned for tax purposes. To qualify under the grantor trust rules, the interest assigned to the trust must be a property interest. Treas. Reg. § 1.671-1(c), T.D. 7148, 1971-2 C.B. 251. If the conditions of the grantor trust rules are met, the income from such property will be taxed to the donee-beneficiary during the term of the trust.

For a comprehensive discussion of the assignment of income doctrine, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 Tax L. Rev. 293 (1962).

however, the fee owner gave away the fee, the transfer of a property interest would be effective for tax purposes, and income accruing after the date of the gift would be taxed to the donee.

The income versus property issue is not new to federal taxation. One issue debated in Congress prior to adoption of the first permanent income tax was whether an income tax on rents was actually a tax on the rental property.[3] If so, it was argued, the Constitution required the tax to be apportioned among the states according to population.[4] Because an income tax could not be so apportioned, the Supreme Court declared the tax unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*[5] The Court could not resist the notion that a tax on income derived from property is intrinsically the same as a tax on the property itself. This facet of the income versus property issue was laid to rest in 1913 with the adoption of the sixteenth amendment which authorized Congress to tax all income "from whatever source derived, without apportionment among the several states."

This Article will examine the decisional law dealing with the income versus property issue, with particular focus on the relationship between capital gain and gift cases. For example, if a gratuitous assignment of rent is disregarded for tax purposes, does it necessarily follow that a sale of a right to rent should be treated as the sale of an income interest taxable at ordinary rather than capital rates?

It is important to note at the outset that although the verbal formulation of the issue is the same in capital gain and assignment of income cases, that is, whether a property interest or an income interest was transferred,[6] the purposes for distinguishing property from income in these two categories of cases are quite different. The principal justification for the present scheme of capital gain taxation is that it mitigates the harsh effects of a progressive rate structure on appreciation accrued over a long period of time but realized in a

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[3]26 CONG. REC. 6826-27 (1894).

[4]"No Capitation or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4. It was generally assumed that a property tax of the type commonly used today by counties and municipalities was a direct tax subject to the apportionment clause.

[5]157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).

[6]In some capital gain cases, the courts have focused upon whether a sale or exchange has occurred. Under this analysis, capital gain treatment depends upon whether the transferor sold his entire interest in the property. If he retained an interest, there is no sale and capital gain treatment is denied. Of course, an identical result could be achieved by analysis of what was transferred. A transfer of less than the entire interest in the property is a transfer of an income interest rather than a transfer of property. *See* text accompanying note 58 *infra*.

single year.[7] This bunching of income problem could, of course, be dealt with in other ways, such as averaging the gain over the holding period of the asset or requiring recognition of appreciation which has not been realized through a sale or exchange.[8] The comparative merits of these possibilities are not considered here. Congress has chosen to deal with the bunching problem by taxing capital gains at a lower rate than ordinary income. In deciding whether a given item is a property interest qualifying for capital gain treatment or an income interest which does not qualify, it is appropriate to keep that legislative purpose in mind.

The principal justification for the assignment of income doctrine is to preserve rather than ameliorate the effect of progressive taxation. If a parent with total taxable income of $100,000 could assign $25,000 to a child, total taxes would be reduced even though the child is taxed on the amount he received because neither would pay tax at the rate applicable to $100,000 of taxable income. Before taxes can be reduced through income splitting, the assignment of income doctrine requires that the source of the income, for example, the fee simple interest in real estate generating rent, be assigned. If a taxpayer were permitted to split off and assign a mere income interest, high rates of taxation could be avoided too easily. Requiring a complete transfer of the donor's entire interest lends substantiality to the transaction and justifies its recognition for tax purposes.

An important objective of this Article is to identify common strands running through the cases as an aid in the difficult task of characterizing borderline transactions for capital gain and assignment of income purposes. The vast majority of interests clearly fall into either the income or property category. For example, interest coupons in the hands of a bondholder which represent nothing more

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[7]*See* Emory, *The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues*, 29 TAX L. REV. 3, 94 (1973). Additional justifications sometimes advanced are unconvincing. *See id.* at 94-95.

[8]Whether a tax on unrealized appreciation would be constitutionally permissible has never been decided by the Supreme Court. The landmark case of Eisner v. Macomber, 252 U.S. 189 (1920) (holding stock dividends to be outside the scope of income taxable under the sixteenth amendment), generally supports the proposition that unrealized appreciation cannot be taxed. The continued validity of *Eisner v. Macomber* has been questioned. One commentator has suggested that whatever remains of *Eisner v. Macomber* "be consigned to the junk yard of judicial history." J. SNEED, THE CONFIGURATIONS OF GROSS INCOME 125 (1967). If a scheme could be devised for overcoming the administrative and judicial problems of taxing unrealized appreciation and Congress chose to adopt it, the Supreme Court would probably uphold it. *See* Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151 (1964). "Today the Court's tolerance for the tax has reached the point where it would be very surprising if anything which there was a reasonable basis for taxing under the income tax was found to be beyond Congress' constitutional competence." *Id.* at 153.

than the right to collect interest clearly represent income and not property for tax purposes. If they are severed from the bonds and transferred by gift, the donor will be taxed on the interest collected by the donee.[9] If they are severed from the bonds and sold, the seller will be taxed at ordinary rather than capital rates.[10] It is equally clear that the bond itself is property, even though it carries with it the right to collect future interest.[11] If sold, the gain generally qualifies for capital gain treatment.[12] This Article focuses on certain types of interests which are problematical. These include leaseholds; life estates; oil, gas, and mineral interests; franchises; and personal service contracts. In the interest of convenience and clarity, the cases are categorized according to the type of interest involved.

II. Leaseholds

A. *Capital Gain Versus Ordinary Income*

The characterization question most frequently arises when a lessor receives something other than rent in connection with a lease. In *Hort v. Commissioner*,[13] the seminal decision, the Court denied capital gain treatment to a lessor who received $140,000 in exchange for cancellation of a lease which had become onerous to the lessee. Conceding that the lease was "property," the Court concluded that "[i]t is immaterial that for some purposes the contract creating the right to such payments may be treated as 'property' or 'capital.'"[14] For the purpose of applying the capital gain provisions, the Court held that the lump sum payment was not a return of capital but a substitute for future rent which would have been taxed as ordinary income.[15]

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[9]Commissioner v. Horst, 311 U.S. 112 (1940).

[10]*See* Shafer v. United States, 204 F. Supp. 473 (S.D. Ohio 1962), *aff'd*, 312 F.2d 747 (6th Cir. 1963).

[11]This conclusion is implicit in Commissioner v. Horst, 311 U.S. 112 (1940). The Court characterized interest coupons as representing income *because* the bondholder "separated his right to interest payments from his investment and procured the payment of the interest to his donee . . . ." *Id.* at 120.

[12]Of course, amounts representing payment for accrued interest are not received in exchange for property and cannot qualify for capital gain treatment even if received in connection with sale of the bond. First Ky. Co. v. Gray, 309 F.2d 845 (6th Cir. 1962). Amounts received for the right to collect principal at maturity and the right to collect interest accruing between the date of sale and maturity will qualify for capital gain if the bond is a capital asset (not held for sale to customers in the ordinary course of business), has been held for more than one year, and was not originally issued at a discount from face value. *See* I.R.C. §§ 1221-1222, 1232.

[13]313 U.S. 28 (1941).

[14]*Id.* at 31.

[15]*Id.* Similar treatment has been accorded a lump sum payment received in ex-

This substitution analysis looks to the result of applying the capital gain provisions. If the result is deemed incompatible with the congressional intent of taxing an item as ordinary income, the item cannot be property within the meaning of the capital gain provisions regardless of its characterization under local law. The foregoing does not mean, however, that all substitutes for ordinary income fail to qualify for capital gain treatment. The Fifth Circuit has stated:

> [Past Supreme Court decisions cannot be interpreted] to mean that any money paid which represents the present value of future income to be earned is always taxed as ordinary gains. As a legal or economic position, this cannot be so. The only commerical value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income.[16]

A lump sum substitute for future dividends realized on the sale of stock may qualify for capital gain rates because a sale of stock represents a complete transfer of the taxpayer's entire interest in the property. It is therefore appropriate to regard the lump sum as a return *of* capital, not a return *on* capital. The lump sum in *Hort* was not a return of capital because the taxpayer retained his ownership of the building. If, however, the taxpayer had disposed of his entire interest in the building and leasehold in exchange for a lump sum partly attributable to future rents to be collected under the lease, capital gain treatment would undoubtedly have been allowed. Thus, an amount received in exchange for rights under a lease may or may not qualify for capital treatment depending on whether the transaction terminates the taxpayer's interest in the property.

In some cases the lessor rather than the lessee may wish to terminate the lease and may agree to make a lump sum payment. The receipt of such a payment by the lessee does not usually raise a substitution for income question because the leasehold interest will not normally be a direct source of ordinary income to the lessee. From the perspective of the lessee, the leasehold is beyond the scope of the *Hort* rule and is recognized as property for tax purposes.[17] The leasehold may be a capital asset under section 1221 if not used in a trade or business or a section 1231 asset if used in a trade or business.[18] In either case the transaction normally qualifies

change for a reduction in rent. *See* Oliver v. Commissioner, 364 F.2d 575, 579-80 (8th Cir. 1966) (citing *Hort v. Commissioner*).

[16]United States v. Dresser Indus., Inc., 324 F.2d 56, 59 (5th Cir. 1963).

[17]Commissioner v. Golonsky, 200 F.2d 72, 73-74 (3rd Cir. 1952).

[18]*See* Rev. Rul. 72-85, 1972-1 C.B. 234.

for capital gain treatment.[19] Capital gain treatment has also been upheld when the lessee received money in exchange for releasing the lessor from a restrictive covenant.[20]

Lessees have had greater difficulty getting capital gain treatment in connection with subleases. A cancellation payment from the sublessee to the lessee-sublessor is usually taxed as ordinary income under the substitution doctrine of *Hort* because the sublease was a source of ordinary income.[21]

To the contrary is *Miller v. Commissioner*.[22] In *Miller* the taxpayer held a lease and paid rent of $1,650 per month. The property was subleased at a monthly rental of $1,885. Two years after the sublease was entered into, it was cancelled and the headlease assigned to the sublessee for a single payment of $32,000. The $32,000 presumably represented the present value of the difference between $1,885 monthly rental on the sublease and $1,650 monthly rental on the headlease which would have been taxed as ordinary income to the taxpayer had he continued to hold the lease and the sublease. In rejecting the Commissioner's argument that the $32,000 was subject to tax at ordinary rates under the substitution doctrine, the Tax Court distinguished *Hort* on the ground that the taxpayer in *Miller* completely terminated his interest in the property upon receipt of the payment, whereas in *Hort* the taxpayer continued to own the property in fee simple. The court stated:

> By assignment [of his leasehold interest] petitioner disposed of his *entire interest* in the property and the fact that the sublessee provided the consideration therefor and entered into an agreement to cancel the sublease does not alter the inescapable conclusion that a sale of income-producing property occurred. . . .
>
> . . . .
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> . . . Had there been merely a cancellation of the sublease without the assignment, petitioner would have retained his

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[19]At one time the Commissioner unsuccessfully urged that capital gain treatment should be denied for lack of a sale or exchange. Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952). The matter was settled in 1954 with enactment of I.R.C. § 1241 which provides that amounts received by a lessee for cancellation of a lease shall be considered as amounts received in exchange for such lease. Internal Revenue Code of 1954, Pub. L. No. 591, § 1241, 68A Stat. 333.

[20]Ray v. Commissioner, 210 F.2d 390 (5th Cir. 1954), *aff'g* 18 T.C. 438 (1952) (distinguishing the lump sum payment in *Hort* as payment of anticipated rent).

[21]Rev. Rul. 129, 1953-2 C.B. 97.

[22]48 T.C. 649 (1967). *See also* Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960).

leasehold interest in the property and realized ordinary income in the form of liquidated rental payments.[23]

In a 1972 Revenue Ruling, the Internal Revenue Service (IRS) permitted capital treatment for gain or loss realized by a lessee on the transfer of his entire leasehold interest to a third party.[24] Prior to transfer of the leasehold, the lessee had improved and subleased the leased property. The ruling does not suggest that the lessee's gain might be regarded as a substitute for ordinary income on the sublease, presumably because, as in *Miller*, the lessee disposed of his entire interest in the leasehold.

Generally, if one is realizing ordinary income directly from a lease, either as lessor or lessee-sublessor, any disposition of the leasehold interest which is less than a complete disposition of the transferor's entire interest in the leasehold as well as the underlying property will give rise to ordinary income under the substitution doctrine.[25] A complete disposition will avoid the doctrine.[26] The termination of interest limitation on the substitution doctrine of *Hort* is necessary because the application of *Hort* pervasively to all amounts which represent substitutes for ordinary income would vitiate the capital gain provisions, at least so far as income-producing property is concerned. Thus, it is reasonable to assume that the term "property" as used in the capital gain provisions includes property which is productive of ordinary income, but it does not include a limited income-producing interest carved out of a larger interest owned by the taxpayer.

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[23]48 T.C. at 653-54 (emphasis added). *Cf.* Voloudakis v. Commissioner, 274 F.2d 209 (9th Cir. 1960) (payments to lessee-sublessor who had a reversionary interest in the lease held ordinary income).

[24]Rev. Rul. 72-85, 1972-1 C.B. 234.

[25]Payments received by lessors for damage to leased property are not, of course, substitutes for rent. Ordinarily, such payments qualify for capital gain treatment without regard to the termination of interest rule. *See* Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220 (2d Cir. 1975) (compensation by lessee for certain fixtures belonging to lessor should be treated as received in exchange for the fixtures); Boston Fish Market Corp. v. Commissioner, 57 T.C. 884 (1972) (cash payment received by lessor in settlement of lessee's obligation to restore leasehold to original condition held taxable as capital gain to the extent it exceeded the cost of the restoration); Hamilton Main, Inc. v. Commissioner, 25 T.C. 878 (1956) (compensation for damage to leased building a return of capital and applied to reduce the lessor's basis). *Cf.* Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944) (compensation for injury to goodwill treated as return of capital).

Compensation for related expenses, however, has been denied capital gain treatment. Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220 (2d Cir. 1975) (compensation for expense of removing debris abandoned by lessee held ordinary income).

[26]*Compare* Rev. Rul. 129, 1953-2 C.B. 97, *with* Rev. Rul. 72-85, 1972-1 C.B. 234.

B. Assignment of Income Doctrine

Although the Supreme Court has not ruled on the question of whether leaseholds can be gratuitously assigned for income tax purposes, the IRS and several circuit courts have considered the issue.

The IRS apparently applies the same standard for assignment of income purposes as the courts have applied for capital gain purposes. For the assignment to be effective for income tax purposes, it must be a transfer of the taxpayer's complete interest in the property, not a limited interest carved out of a larger estate. Revenue Ruling 58-337[27] involved the transfer of a leasehold interest by the fee owners to a ten-year trust for the benefit of the grantors' children. In ruling that the grantors would continue to be taxed on the rental income the Service stated:

> Prior to the creation of the trust in the instant case, the fee owners had carved out of their ownership two separate estates, a leasehold and a reversion. The leasehold was then made the subject of the trust here involved. When a fee owner/lessor assigns a lease without assigning the reversion, only the right to the rent passes to the assignee. Accordingly, the assignment of the lease in trust without an attendant assignment of the reversion constitutes an assignment of income for which the grantor remains taxable, since he may not escape the tax on his income by giving it away or assigning the right to receive it in advance of payment.[28]

The Service buttressed its argument by noting that the leasehold itself was not transferred absolutely because the trustee was prohibited by the trust instrument from reassigning the leasehold. It is doubtful, however, that the restriction on reassignment was crucial to the holding.

In *Iber v. United States*,[29] the taxpayer owned real estate subject to a lease and transferred the lease to a ten-year trust.[30] The government argued that "an assignment of a lease by one who continues to hold the reversionary interest in the land *never* constitutes a transfer of income-producing property."[31] The Court of Appeals for the Seventh Circuit declined to adopt so broad a rule,

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[27]1958-2 C.B. 13.

[28]*Id.* at 13.

[29]409 F.2d 1273 (7th Cir. 1969).

[30]Under the grantor trust rules of I.R.C. §§ 671-677, one may transfer income producing property to a trust for 10 years or more and have the income distributed and taxed to another person during the life of the trust. These rules represent a statutory exception to the assignment of income doctrine.

[31]409 F.2d at 1275.

holding instead that the transfer was ineffective because the assignor retained a reversionary interest in the leasehold.[32] Nevertheless, the opinion focuses upon the fact that title to the income-producing property remained with the assignor and that deductions for depreciation and real estate taxes had been claimed by the assignor after he had assigned the lease.[33] The implication is clear that the assignor would have been taxed on the rental income even if he had transferred the entire leasehold retaining a reversion only in the underlying property. Otherwise, the income interest could be separated and assigned while deductions attributable to the production of the income were claimed by the taxpayer.

Contrary to the implication of *Iber* that a leasehold can never be effectively assigned by the fee owner is *Lum v. Commissioner*.[34] In *Lum* the owner-lessor assigned by gift all of his rights as landlord, retaining no interest whatever in the leasehold. Although the assignor took deductions for real estate taxes, maintenance expense, and depreciation on the leased property, the Third Circuit Court of Appeals concluded that the assignment constituted a transfer of income-producing property. Rental income was held taxable to the assignee.[35]

In ruling upon a set of facts similar to those of *Lum*, the Fourth Circuit rejected the taxpayer's contention that more than a right to income was assigned, noting that "[t]he taxpayer does not suggest what these additional rights were and we have been unable to discover them."[36] During the term of the lease the taxpayer claimed deductions for taxes, maintenance expense, and depreciation. The court found these deductions indicative of an intent to retain ownership of the reversion and to transfer to the donee only the leasehold, which consisted of little more than a right to rent.[37] Although the assignee received a property interest under state law, the court characterized it as a nonassignable income interest for purposes of federal taxation.[38]

The Seventh and Fourth Circuits hold that the gratuitous assignment of a leasehold by one who owns the underlying property will be ineffective to shift the incidence of tax on the rent. This conclusion is consistent with the treatment of leaseholds under the capital gain provisions in which sale of the leasehold by the owner of

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[32]*Id.*
[33]*Id.* at 1276.
[34]147 F.2d 356 (3d Cir. 1945).
[35]*Id.* at 357.
[36]United States v. Shafto, 246 F.2d 338, 342 (4th Cir. 1957).
[37]*Id.* at 343.
[38]*Id.*

the underlying property is treated as sale of an income interest giving rise to ordinary income rather than capital gain.

The Third Circuit's treatment of the assignment of a leasehold by one who owns the underlying property as the assignment of a property interest effective for tax purposes is inconsistent with the capital gain cases and with the fundamental principle that income derived from property is taxed to the owner of the property. In an economic sense, only the physical property itself is productive of income. The leasehold is nothing more than a legal arrangement entered into by the owner of the property for exploitation of its economic value. As the Third Circuit recognized, there is merely a technical distinction between assignment of a leasehold and assignment of a right to collect rent.[39] That distinction fails to justify recognition, for income tax purposes, of the assignment of a leasehold but not the assignment of a mere right to collect rents.[40]

If the leasehold is assigned along with ownership of the underlying property, rent accruing after the date of assignment is taxable to the assignee as owner of the property. In the case of a transfer to a ten-year trust, rent is taxable to the assignee even though the assignor does not make a complete transfer of his entire interest in either the leasehold or the underlying property. For example, if, as in the *Iber* case, a taxpayer owns real estate subject to an eleven-year lease, the rental income can be assigned by transferring title to the underlying property as well as the leasehold to a properly qualified ten-year trust. The trustee is entitled to deductions for real estate taxes, maintenance expense, and depreciation during the term of the trust, and it is appropriate for the income to be taxed to the trustee or to the trust beneficiaries under the normal rules of trust taxation.

Although there are no cases directly on point, a lessee should be able to assign a leasehold interest by gift if he assigns his entire interest in the leasehold and has no interest in the underlying property. In the *Miller* case the taxpayer-lessee who was obligated to pay rent of $1,650 per month subleased the property for $1,885 per month. The leasehold itself was a valuable income-producing interest which was sold for $32,000. The Tax Court characterized the transaction as a sale of property qualifying for capital gain treatment. By

[39]The court characterized the distinction as "technical but real," "real" in the sense that if rent were asigned, "the landlord retained his interest and made a gift of the rent," whereas if the leasehold were assigned, "he transferred his interest as landlord." Lum v. Commissioner, 147 F.2d at 357. The court's analysis lacks substance.

[40]The courts are unanimous in holding the gratuitous assignment of a right to rent ineffective for tax purposes. Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954); Ward v. Commissioner, 58 F.2d 757 (9th Cir. 1932); Bing v. Bowers, 22 F.2d 450 (S.D.N.Y. 1927).

analogy, a gratuitous transfer of the leasehold would qualify as a transfer of income-producing property effective for tax purposes.

III. Life Estates

A. *Assignment of Income Doctrine*

In *Blair v. Commissioner*,[41] the owner of a life estate in a testamentary trust gave to his daughter an income interest amounting to $9,000 per year for the duration of the life estate. The income versus property issue was particularly acute. If, in accordance with economic reality, the life estate were treated as a nonassignable income interest for tax purposes, the taxpayer could never assign the income even if he were to make a complete gift of his entire life estate because he would be powerless to assign the underlying property. On the other hand, if the life estate were unqualifiedly recognized as income-producing property, nothing would prevent the taxpayer from assigning any portion of it he chose. He could assign or keep the income on a year-by-year basis.

The Supreme Court observed that the taxpayer did not attempt to "limit the assignment so as to make it anything less than a complete transfer of the specified interest" assigned.[42] Because there was a complete transfer of a vertical slice of the life estate, the Court held the assignment effective for income tax purposes.[43]

In *Harrison v. Schaffner*,[44] the life beneficiary of a trust assigned to her children income from the trust for a one-year period. Unlike *Blair*, *Harrison* did not involve a complete transfer of a specified interest. In holding the transfer ineffective for tax purposes, the *Harrison* Court stated:

> We think that the gift by a beneficiary of a trust of some part of the income derived from the trust property for the period of a day, a month or a year involves no such substantial disposition of the trust property as to camouflage the reality that he is enjoying the benefit of the income from the trust of which he continues to be the beneficiary. . . . Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest in it, we have not allowed the form to obscure the reality.[45]

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[41] 300 U.S. 5 (1937).
[42] *Id.* at 13.
[43] *Id.* at 14.
[44] 312 U.S. 579 (1941).
[45] *Id.* at 582-83.

Blair clarified that the complete transfer of a life estate would be recognized as a transfer of income-producing property for tax purposes. *Harrison* obscured the issue by holding that an interest in a life estate limited to one year, which is a thin horizontal slice of the life estate, would not be recognized because the taxpayer did not make a "substantial disposition of the trust property."[46] What would qualify as a substantial disposition was not addressed by the Court.

In 1955 the IRS ruled that a gratuitous, irrevocable assignment of a life estate for a period of not less than ten years would be recognized for tax purposes and the income would be taxable to the assignee.[47] The ruling was a pragmatic one in view of the fact that a life estate, transferable in its entirety under *Blair*, could be effectively transferred by gift for a ten-year period under sections 671-677 of the IRC. The economic effect of transferring a life estate to a ten-year trust with income payable to a donee-beneficiary would be identical with a direct transfer to the donee of a ten-year interest in the life estate. Thus, the IRS position is reasonable in view of the statutory provisions.

B. Capital Gain Versus Ordinary Income

In *McAllister v. Commissioner*,[48] the taxpayer transferred her entire life interest in a trust to the remainderman for $55,000. Relying on *Hort*, the Commissioner argued that the $55,000 was received as consideration for a right to income which would have been taxed at ordinary rates if distributed as earned, and that the $55,000 should therefore be taxed at ordinary rates under the substitution for income doctrine. The Court of Appeals for the Second Circuit relied upon the decision in *Blair* that the gratuitous transfer of an income interest in a trust was the assignment of a property right with subsequent income, taxable to the donee,[49] and held the transaction to be a disposition of property taxable at capital gain rates.[50] The court had some difficulty in distinguishing the *Hort* case:

> Here the line of demarcation between the *Blair* and *Hort* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all

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[46] *Id.* at 582.
[47] Rev. Rul. 55-38, 1955-1 C.B. 389.
[48] 157 F.2d 235 (2d Cir. 1946).
[49] *Id.* at 236.
[50] *Id.*

> would agree that there is some distinction between selling a life estate in property and anticipating income for a few years in advance. . . . The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate at least is.[51]

Although *McAllister* and *Hort* both involved a gain on a sale, the *McAllister* court distinguished *Hort* and relied upon *Blair* which involved a gift. Was it simply that *McAllister* and *Blair* each involved disposition of a substantial and durable property interest, whereas *Hort* did not? Although the court's language supports this conclusion, it provides no explanation as to why the fifteen-year leasehold in *Hort* with nine years remaining and annual rent of $25,000 was not a substantial and durable property interest.

The court probably characterized the life estate in *McAllister* as a property interest because the taxpayer had assigned his entire interest in the property, whereas in *Hort* the taxpayer-lessor merely terminated a lease and continued to hold the property as a fee owner. *McAllister* and *Hort* can be reconciled only if termination of interest rather than durability is regarded as the appropriate test for determining the property versus income issue. Admittedly there is no direct support for the termination of interest analysis in the *McAllister* case. Nevertheless, termination of the transferor's interest was the only sound reason for the Supreme Court's holding in *Blair* that property rather than income was transferred. *McAllister* relied upon *Blair* and thus presumably upon a termination of interest theory.

Most life estates are acquired either by gift or bequest. The basis determined under sections 1014 or 1023 in the case of a bequest, or section 1015 in the case of a gift, cannot be amortized.[52] At the time of the *McAllister* decision, however, the basis could be used to reduce gain on a sale, thus providing a great incentive for sale. Congress subsequently modified the effect of *McAllister* with section 1001(e) which provides that upon sale of a life estate any basis determined under sections 1014, 1023, or 1015 shall be disregarded.[53] Thereafter, the IRS announced that it will follow the holding of

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[51] *Id.* at 235, 237 (emphasis added).

[52] I.R.C. § 273.

[53] In 1976 when § 1023 was adopted, Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 182-77, § 1001(e) was not amended to apply to bases determined under § 1023. However, § 1001(e) was so amended in 1978. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2928.

McAllister with respect to a sale by a life beneficiary of his entire interest.[54]

IV. Oil, Gas, and Mineral Interests

A. *Capital Gain Versus Ordinary Income*

Under the rule of *Hort*, one who owns real estate may not sell a leasehold and retain the underlying property for purposes of the capital gain provisions. The proceeds of such a "sale" are taxed as rental income. If one owns real estate upon which a natural deposit exists, however, he is regarded as holding two separate assets: the real estate and the deposit. The deposit may be sold in place for a fixed consideration and the gain taxed at capital rates.[55] The seller, having sold the depletable asset, will not be entitled to deductions allowed for depletion.[56] No substitution for income issue will arise by virtue of the seller's retention of the underlying real estate.

On the other hand, if the owner engages in the busines of exploiting the deposit he will qualify for the depletion allowance, but resulting income will be taxed at ordinary rates because no sale or exchange is involved.[57] He may also engage in exploitation indirectly by entering into a lease or contract whereby others will carry on exploitation activities. In the latter case, it may be unclear whether the owner has sold the natural deposit in place with gain taxed at capital rates,[58] or has arranged for exploitation of the deposit with income subject to depletion and taxed at ordinary rates.

The touchstone which emerges from several oil and gas cases decided by the Supreme Court is whether the owner has retained an economic interest in the deposit.[59] If an economic interest has been retained, no sale has occurred and income is taxed at ordinary rates subject to depletion. If no economic interest has been retained—the deposit has been sold in place, payments received by the seller may qualify for capital gain treatment, but the seller will not be entitled to any depletion allowance. Most of the Supreme Court decisions involved taxpayers who had assigned exploitation rights to a natural

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[54] Rev. Rul. 72-243, 1972-1 C.B. 233.

[55] Whitehead v. United States, 555 F.2d 1290 (5th Cir. 1970). *See* Treas. Reg. § 1.221-1.

[56] *See* Treas. Reg. § 1.611-1(b).

[57] *See id.*

[58] *See, e.g.*, Cox v. United States, 497 F.2d 348 (4th Cir. 1974); United States v. White, 401 F.2d 610 (10th Cir. 1968); Commissioner v. Remer, 260 F.2d 337 (8th Cir. 1958).

[59] *E.g.*, Commissioner v. Bankline Oil Co., 303 U.S. 362 (1938); Thomas v. Perkins, 301 U.S. 655 (1937); Palmer v. Bender, 287 U.S. 551 (1933). *See* 4 J. Mertens, Law of Federal Income Taxation § 24.21 (1977).

deposit in exchange for some form of periodic payment. Typically, the taxpayer-assignor attempted to treat the transaction as an exploitation arrangement producing ordinary income, with attendant depletion allowances, rather than as a sale.[60] The Commissioner urged that the taxpayer had sold his economic interest in the oil or gas deposit and thus had nothing to deplete.[61]

Although most of the cases in which the economic interest test was developed involved the availability of deductions for depletion rather than the availability of capital gain treatment, the determinative question for both purposes is the same: whether a sale occurred. Thus, the economic interest test applies to the determination of whether a transaction involves a sale of a natural deposit or an exploitation contract.[62] Several Supreme Court decisions provide a foundation for the economic interest test. These decisions merit careful evaluation.

Although the Court in these cases focused on whether a sale had occurred, the economic interest test which it applied is identical in substance to the test applied in *Hort* for the purpose of determining whether a property interest or an income interest had been sold. Here, just as under *Hort*, a retained interest will negate capital gain treatment. The only difference is a superficial one in that here a retained interest breaches the sale or exchange requirement, whereas under *Hort* it breaches the property requirement.[63]

In considering the cases, it is important to keep in mind the distinction between two forms of payment commonly used in oil, gas, and mineral transactions. One who owns a natural deposit in place is said to hold the "working interest" because he has the power of exploitation. He may transfer the working interest to another in exchange for a royalty which entitles him to a specified percentage of production without limitations on the total amount which may be

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[60]*But see* text accompanying note 69 *infra* for a discussion of Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946), which applied the economic interest test for a purpose other than determining the availability of depletion deductions.

[61]*See* Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1945); Palmer v. Bender, 287 U.S. 551 (1933). Both cases are discussed in the text accompanying notes 64-68 *infra*.

[62]Vest v. Commissioner, 481 F.2d 238 (5th Cir. 1973). "[I]t has also been recognized on several occasions that regardless of the original purpose of the economic interest test, it is substantially the same as the test employed to determine whether income is taxable as capital gain or ordinary income." *Id.* at 242. *But see* Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957).

[63]This parity of treatment is entirely appropriate. In applying the capital gain provisions, uniform standards should be applied irrespective of the subject matter of the transaction. If a retained interest disqualifies a transaction involving a leasehold or a life estate, it should also disqualify a transaction involving a natural deposit or a franchise.

received. As an alternative, he may receive only a "production payment" entitling him to a specified percentage of production up to a specific dollar amount. In short, the production payment is like a royalty except that it provides for a maximum amount payable. The distinction between a royalty and a production payment has been a significant factor in applying the economic interest test.

1. Cases Involving Royalties or Other Unlimited Payments.— Palmer v. Bender,[64] the first Supreme Court decision applying the economic interest test, concerned taxpayers who had acquired, through a lease, complete control of an oil deposit. Although referred to as lessees, the taxpayers clearly owned the deposit in place and were free to sell it outright for a lump sum or to exploit it themselves. Instead, the taxpayers assigned the exploitation rights to an oil company in exchange for (1) an immediate cash payment, (2) a deferred payment of $1,000,000 to be paid out of one-half of the first oil produced, and (3) a royalty of one-eighth of all oil produced. The Commissioner urged that inasmuch as taxpayers transferred all of their rights in the deposit, the transaction was a sale rather than a sublease under applicable state law and that the taxpayers were not entitled to depletion deductions. Noting that whether the transaction was a sale or a sublease under state law is immaterial for federal tax purposes, the Supreme Court held that the taxpayers "retained, by their stipulations for royalties, an economic interest in the oil in place identical with that of a lessor."[65] Through the royalty agreement, the taxpayers shared in the oil produced and in the risk of the oil being destroyed. Since the taxpayers retained an economic interest, they were entitled to an equitable portion of the depletion allowance.[66] It was thus established that a retained royalty based on output or production is a retained economic interest.

In *Kirby Petroleum Co. v. Commissioner*,[67] the owner in fee of the real estate leased it for the production of oil, gas, and other minerals. The lessee agreed to pay the taxpayer a lump sum bonus, a royalty based on production, and twenty percent of the net profits realized from exploitation under the lease. The Commissioner allowed depletion deductions based on royalty payments and the bonus, which was regarded as an advance royalty, but denied depletion based on income derived from the profit sharing arrangement. In overruling the Commissioner, the Court stated:

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[64]287 U.S. 551 (1932).

[65]*Id.* at 558.

[66]When more than one party has an economic interest in a depletable asset, the depletion allowance must be equitably apportioned. I.R.C. § 611(b).

[67]326 U.S. 599 (1946).

> If the additional payments in these leases had been a portion of the gross receipts from the sale of oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to a share of net profit.[68]

Burton-Sutton Oil Co. v. Commissioner[69] involved a similar transaction wherein the taxpayer, an oil company engaged in exploitation activities, had obtained an oil lease by assignment, and agreed to pay the lessee-assignor fifty percent of the net profit realized from production. The taxpayer deducted these payments on the theory that the lessee-assignor retained an economic interest in the deposit and that the payments were similar to rent on a sublease. The Commissioner denied the deduction, claiming that the lessee-assignor had sold its entire interest and the payments were nondeductible acquisition costs.

The government attempted to distinguish *Kirby* wherein the taxpayer had retained a right to royalties based on production as well as a right to share in net profits. The Court responded:

> We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possessor of a right to share in net profits the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.[70]

The Court observed that one could divest himself of his economic interest as by a sale for cash, but that no such divestment occurs where one retains an interest in net profits. Because the lessee-assignor had retained an economic interest through the profit sharing arrangement, the taxpayer had not purchased the lease and was entitled to deduct profit sharing payments. *Burton-Sutton* clarifies that the owner of a deposit who assigns the working interest in exchange for a right to share in net profits has retained an economic interest.[71]

In *Commissioner v. Southwest Exploration Co.*,[72] the taxpayer

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[68]*Id.* at 604.

[69]328 U.S. 25 (1946).

[70]*Id.* at 32.

[71]*Id.* at 36. *Cf.* Commissioner v. Elbe Oil Land Dev. Co., 303 U.S. 372 (1938) (holding that a profit sharing arrangement did not constitute a retained economic interest in the transferor was limited to its facts).

[72]350 U.S. 308 (1956).

owned real estate which was upland from oil deposits off the coast of California but held no interest in the oil deposits themselves. Under state law the offshore oil could be recovered only by slant drilling from the uplands. The taxpayer entered into an agreement with Southwest Exploration whereby Southwest would recover the offshore oil through drilling operations conducted on taxpayer's property. The taxpayer received a percentage of the net profits and took a deduction for depletion.

In determining whether the taxpayer was entitled to depletion, the Court noted that to qualify for the deduction one must have acquired an interest in the oil in place. Although the taxpayer had no direct ownership interest in the offshore oil, use of the uplands was essential to exploitation and the Court thus held that the taxpayer had an economic interest in the oil in place.[73] The economic interest consisted of control over exploitation which could have been sold to Southwest for a stated sum of money. Instead, the taxpayer retained an economic interest by permitting use of the uplands for a share of the profits. Income derived therefrom was ordinary income subject to depletion.

Under these Supreme Court decisions, the owner of a natural deposit who has arranged for exploitation in a manner which makes his return dependent upon royalties, net profits, or other measures of production has retained an economic interest in the deposit.[74] Although the decisions did not deal directly with the capital gain versus ordinary income issue, it is apparent that one who has retained an economic interest has not terminated his interest in the deposit; thus, the rule of *Hort* denies capital gain treatment. Although the lower courts have accepted this proposition,[75] they have had difficulty applying the economic interest test.

According to the Eighth Circuit's decision in *Commissioner v. Remer*,[76] making payment of the purchase price a function of produc-

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[73]*Id.* at 316.

[74]For one to retain an economic interest in connection with an exploitation transaction, it is necessary that he hold such an interest before the transaction. One who owns the deposit in place, that is, holds the exploitation rights and is entitled to all income therefrom, clearly holds an economic interest. Since our concern is with how such a taxpayer's exploitation transaction will be characterized, the issue of whether more limited interests may also qualify as economic interests will not be discussed. *Compare Southwest Exploration Co.* (fee owner of land adjoining that on which deposit existed who, by virtue of such proximity to the deposit, controlled production had an economic interest in the deposit), *with* Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624 (1965) (mine operator's contract right to mine coal for sale to mine owner at a certain price did not give operator an economic interest in the coal in place). *See generally* 4 J. MERTENS, *supra* note 59, § 24:21, at 83-87.

[75]*See* note 62 *supra*.

[76]260 F.2d 337 (8th Cir. 1958).

tion will not in itself cause an economic interest to be retained by the transferor. In *Remer* the taxpayer transferred mineral leases in exchange for lump sum payments plus ten cents per ton of mineral extracted by the transferee. In upholding capital gain treatment the court stated:

> The written assignments were in the language of an absolute sale under warranty of title and contained no provision retaining any interest in the property so sold. The provision in the assignments for the payment of ten cents per ton on such concentrates as might be shipped imposed no obligation on the transferee to ship any ore, and the transferor retained no interest in the ore in place. The consideration to be paid was definite and absolute and the provision with reference to paying ten cents per ton for the ore shipped was simply a method of measuring the added consideration to be paid. The transferor had the bare right to payments measured by production. This did not, we think, result in the transferor retaining an economic interest in the property sold.[77]

In *Rabiner v. Bacon*,[78] the Eighth Circuit declined to apply the rule of *Remer* to a fee owner of gravel land who was to receive a fixed price per ton of gravel removed. The court stated:

> [T]axpayer's income here was derived solely from the extraction of the mineral and was geared to the production of the mineral. We think it can be safely said that taxpayer retained an economic interest in the subject minerals whether any were mined or not. He had an economic interest in the minerals mined by reason of income he received from the exploitation of his lands and the extraction of the minerals.[79]

Because the taxpayer had an economic interest in the gravel in place, capital gain treatment was denied. The *Remer* case was distinguished as involving the assignment of a mineral lease by a lessee rather than the granting of a mineral lease by a fee holder.[80] This distinction is without merit because a fee holder may make an effective sale of the mineral deposit in place for tax purposes, provided only that he has not retained an economic interest in the deposit.[81]

The Tenth Circuit reached a result contrary to *Remer* in *United*

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[77] *Id.* at 339. *See also* Lineham v. Commissioner, 297 F.2d 276 (1st Cir. 1961).

[78] 373 F.2d 537 (8th Cir. 1967).

[79] *Id.* at 539.

[80] *Id.*

[81] *See* notes 55-58 *supra* and accompanying text.

States v. White,[82] a case involving very similar facts. In *White*, the taxpayer transferred uranium land by an outrigtt mineral deed, retaining no reversionary interest. In exchange, he received a lump sum payment of $175,000 plus ten percent of the gross value of all minerals mined. The taxpayer retained no control over exploitation; the transferee could recover the minerals or not, as he wished. In the first consideration of the case,[83] the Tenth Circuit held that the taxpayer "retained no investment or interest, economic or otherwise, in the minerals in place"[84] and was entitled to capital gain treatment on the lump sum. The court specifically declined to determine the character of the percentage payments.[85]

Six years later, the court considered the same transaction for characterization of the percentage payments.[86] Noting that a single disposition of the mineral rights necessitated a single characterization of the consideration received, the court overruled its earlier decision and concluded that the taxpayer had retained an economic interest and that all amounts realized were properly characterized as ordinary income.[87]

The court in *White* noted that the *Remer* decision was based upon an agreement to pay a fixed amount per unit, whereas the taxpayer in *White* was to receive a percentage of the value of the recovered ore. As the court implied, the distinction is specious[88] because in both cases the taxpayer's return is dependent upon production. The added variable of the recovered ore's value should be immaterial.[89]

2. Cases Involving Production Payments or Other Limited Payments.—The Supreme Court has had some difficulty applying the economic interest test to production payments. A production payment entitles the holder to a specified sum of money payable

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[82]401 F.2d 610 (10th Cir. 1968).

[83]United States v. White, 311 F.2d 399 (10th Cir. 1962), *overruled*, 401 F.2d 610 (10th Cir. 1968).

[84]311 F.2d at 402.

[85]*Id.* at 403.

[86]401 F.2d 610 (10th Cir. 1968).

[87]*Id.* at 614. At least one court has suggested that a retained interest of insignificant value ought not to characterize the entire transaction. Wood v. United States, 377 F.2d 300 (5th Cir. 1967).

[88]*Id.* at 612. *See* Cox v. United States, 497 F.2d 348 (4th Cir. 1974) (lessee who assigned oil and gas leases for a lump sum payment plus a percentage of production had ordinary income); Commissioner v. Pickard, 401 F.2d 615 (10th Cir. 1969); Wood v. United States, 377 F.2d 300 (5th Cir. 1967). "Under the economic interest test, the critical consideration is whether payment is dependent upon extraction, not the method by which that payment is calculated." *Id.* at 306.

[89]401 F.2d at 612.

from production. Unlike a royalty, it contemplates a limited rather than an unlimited return. Should such a limited return be considered dependent on production and therefore an economic interest? At first blush, it would clearly seem so. If one transfers the working interest in an oil deposit to another in exchange for $395,000 to be paid at the rate of twenty-five percent of the oil produced, his return is dependent on production because no return will be realized unless oil is produced. In *Thomas v. Perkins*,[90] the Supreme Court held under similar circumstances that the transferor did not sell the oil in place for $395,000 payable from production, but instead arranged for exploitation while retaining ownership. Thus, the transferor was taxed at ordinary rates on the twenty-five percent portion of the income from production used to satisfy the $395,000 obligation.[91]

It could be argued, however, that a retained production payment should not be regarded as an economic interest. The economic interest test appropriately looks to the risk of ownership to determine whether an interest has been sold.[92] If the transferor continues to bear the risk of ownership, he has not sold his interest. If the transferor is entitled to a specified sum regardless of production, he has shifted the risk of ownership to the transferee. Risk is a double-faceted concept, involving the possibility of gain as well as loss. The transferor in *Perkins* relinquished the possibility of gain beyond $395,000, but the fact that he continued to bear the risk of loss was apparently deemed sufficient to negate a sale.

Three years later, in *Anderson v. Commissioner*,[93] the Court sharply curtailed the rule of *Perkins*. In *Anderson*, oil properties, including fee interests, were transferred in exchange for a specified sum of money payable from oil or gas to be produced and from proceeds realized upon a resale of the fee interests in any of the properties conveyed. Payments due under the agreement were secured by liens on the oil and gas produced and on the fee interests. The Court distinguished *Perkins* on the basis that it involved only a reservation by the transferor of an interest in production, whereas in *Anderson* there was reserved an interest in the fee and in production. "In the interests of a workable rule," the Court observed, "*Thomas v. Perkins* must not be extended beyond the situation in

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[90] 301 U.S. 655 (1937).

[91] *Id.* at 661.

[92] *See* Palmer v. Bender, 287 U.S. 551, 558 (1933). In *Palmer*, the taxpayers possessed an economic interest through a royalty contract, which allowed them to share in the income from the oil produced as well as the loss resulting from the destruction of oil in place. *See id.* at 558.

[93] 310 U.S. 404 (1940).

which . . . the reserved payments are to be derived solely from the production of oil and gas."[94]

After *Perkins* and *Anderson*, a retained production payment payable *solely* from production will be treated the same as a retained royalty and will constitute an economic interest negating a sale; if the production payment is secured by anything other than production it will not be regarded as an economic interest. This technical distinction, which is without practical significance in many instances, probably resulted from the Court's recognition in *Anderson* that *Perkins* was wrongly decided and a reluctance to overrule *Perkins* so soon after it had been decided. Nonetheless, these early Supreme Court decisions mean that establishing a total maximum price, as and when recovered, will not qualify the transaction for capital gain treatment.[95] On the other hand, a fixed price which is to be paid from production if the deposit is exploited but which is due in any event qualifies for capital gain. It does not result in a retained economic interest because the purchase price is not dependent upon production.[96]

As a practical matter, collecting the price depends on production unless there is personal liability on the obligation. Personal liability, however, has not been regarded as crucial. In *Strutzel v. Commissioner*,[67] for example, the taxpayer owned mining rights which gave him power to extract and sell certain mineral deposits. In effect, the taxpayer owned in place any such deposits discovered on the property. He transferred his entire interest for $500,000, payable in fixed installments over a ten-year period. If the transferee exploited the deposits, the taxpayer-transferor was entitled to a five percent production payment which would reduce the fixed installments and the $500,000 purchase price. In the event of default, the mining rights would revert to the taxpayer without further obligation on the part of the transferee.

In upholding capital gain treatment the Tax Court observed that "[p]roduction royalties, if paid, would only serve to accelerate payment of the total purchase price."[98] The court therefore concluded that the provision for a reverter in the event of default did not constitute a retained economic interest.[99] Although the installment payments were not technically dependent on production because they were due in any event, as a practical matter they were dependent. If the claims proved worthless, the transferee could simply

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[94]*Id.* at 413.

[95]United States v. Witte, 306 F.2d 81 (5th Cir. 1962).

[96]Strutzel v. Commissioner, 60 T.C. 969 (1973).

[97]60 T.C. 969 (1973).

[98]*Id.* at 974.

[99]*Id.* at 976.

default and allow the claims to revert to the transferor. Note that capital gain treatment would not have been available if the contract had called for a five percent production payment not to exceed $500,000. This premium on drafting is an unfortunate side effect of the Supreme Court's distinction of *Perkins* in *Anderson*. The Court should have overruled *Perkins* by holding that establishing a maximum price strips the assignor of the principal benefit of ownership, the possibility of speculative gain, without which there is no retention of a meaningful economic interest.[100]

3. Sale of Retained Interest.—A question closely related to that of characterizing the original exploitation transaction may arise if the entire retained interest is transferred at a later date. If the taxpayer disposes of his retained interest and thereafter has no economic interest in the deposit, transfer of the carved-out interest originally retained ordinarily qualifies for a capital gain treatment.[101] This is true even though the carved-out interest would have been productive of the ordinary income to the transferor if he had continued to hold it. Thus, a twelve percent royalty, which yields an average of $15,000 annually taxable at ordinary rates, could be sold for a lump sum payment taxable at capital gain rates. The result is sensible. Because the initial transfer would have qualified for capital gain treatment if it had terminated the taxpayer's interest, the second transfer, which did terminate it, should qualify.

Consistent with this analysis is the Supreme Court's holding in *Commissioner v. Lake*[102] that transfer of a carved-out interest does not qualify for capital gain treatment if the transferor's interest in the deposit is not terminated.[103] In *Lake*, a corporate taxpayer which held oil and gas leases for exploitation transferred to its president an oil payment right[104] in the amount of $600,000, payable from the working interest, in exchange for cancellation of a debt. After payment of the $600,000, the taxpayer would be restored to its original

[100]By the same reasoning a bootstrap sale of a business could qualify for capital gain treatment without violating the principles of the oil, gas, and mineral cases. *See* Commissioner v. Brown, 380 U.S. 563 (1965) (sale of stock in a wholly-owned corporation in exchange for a specified sum to be paid out of post-sale profits held subject to capital gains tax). Three justices dissented, stating that "the sellers here retained an economic interest in the business fully as great as that retained by the seller of the oil interests in *Thomas v. Perkins.*" *Id.* at 586 (Goldberg, Black, J.J., & Warren, C.J., dissenting).

[101]Rev. Rul. 73-428, 1973-2 C.B. 303.

[102]356 U.S. 260 (1958).

[103]*Id.* at 268.

[104]As described by the Court, an oil payment is "the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as and when produced." *Id.* at 261 n.1.

position with respect to the working interest. In short, the taxpayer assigned $600,000 of the future income it expected to realize from the leases.

In holding that ordinary income resulted from the debt cancellation, the Court relied upon its earlier decision in *Helvering v. Horst*[105] that a taxpayer who detached interest coupons from negotiable bonds and made a gift of them to his son was taxable on the interest even though it was paid to his son.[106] The coupons were characterized as income interests which could not be assigned by gift.[107] Similarly, the *Lake* Court characterized the oil payment right as an income interest which could not be sold at capital rates, stating: "Only a fraction of the oil . . . rights were transferred, the balance being retained."[108] Although much of the opinion in *Lake* concerned the type of interest that was transferred, the clear implication was that there could be no capital gain treatment because the source of the income was retained. Under either rationale a complete termination of interest would qualify the transaction as a transfer of property for capital gain purposes.

B. Assignment of Income Doctrine

Although the cases are sparse, the assignment of income doctrine has been applied in a manner consistent with the capital gain decisions. In *Flewellen v. Commissioner*,[109] a taxpayer who owned a royalty interest in an oil well made a gift of a production payment of $3,000 to be paid from the royalties. The Commissioner included the $3,000 in taxpayer's income, although it had been paid directly to the donee. The Tax Court observed that had the production payment been sold, the proceeds would have been taxed as ordinary income under the *Lake* case.[110] Inasmuch as the *Lake* decision rested on assignment of income principles stated in *Horst*,[111] the Tax Court viewed them as controlling and upheld the Commissioner.[112] By assigning a production payment, the taxpayer attempted to strip off an income interest from a larger royalty interest which he owned.

Had the taxpayer in *Flewellen* assigned a vertical slice of his royalty interest, for example, $3,000 per year for the duration of the royalty contract, the assignment would have been recognized for tax

[105]311 U.S. 112 (1940).
[106]*Id.* at 117.
[107]*Id.* at 117-18.
[108]356 U.S. at 265.
[109]32 T.C. 317 (1959).
[110]*Id.* at 322-23.
[111]*See* text accompanying note 108 *supra*.
[112]32 T.C. at 323.

purposes.[113] In *United States v. Spalding*,[114] the holder of a royalty interest in a gas well assigned by gift a percentage of all amounts payable to him in the future under the royalty agreement. Relying on *Blair*,[115] the Court held the transfer effective for tax purposes.

V. Franchises

A. *Capital Gain Versus Ordinary Income*

Many similarities exist between the tax issues raised by the disposition of franchises and those pertinent to gas, oil, and mineral cases. If the transferor of a franchise makes an outright sale retaining no interest in or control over the franchise, it will constitute a sale or exchange of property and will normally qualify for capital gain treatment.[116] An incomplete disposition may be regarded as a licensing transaction producing ordinary income.

Gowdey v. Commissioner[117] illustrates the problems which frequently arise. The taxpayer in *Gowdey* held a Dairy Queen franchise for the state of Virginia which gave him the exclusive right to use patented machines, to use the name "Dairy Queen," and to prepare and sell the product Dairy Queen. Franchise rights for specified territories within Virginia were assigned to various individuals in exchange for an immediate lump-sum payment plus periodic payments of thirty-five cents per gallon of Dairy Queen mix used. The issue was whether the taxpayer had entered into a subfranchise or licensing arrangement resulting in ordinary income or whether he had sold a portion of his statewide franchise.

The Court allowed capital gain treatment for the initial payment, but not for the periodic payments, noting that the assigned franchise privileges could be exercised in perpetuity.[118] Under this analysis, the taxpayer had transferred to each assignee a portion of his entire interest, a vertical slice of the statewide franchise consisting of all substantial rights for a specified territory. The court had some difficulty with the requirement that the taxpayer approve any subsequent transfer of the franchise, but held that the restriction was insufficient to negate a sale.[119]

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[113]*See* text accompanying notes 41-46 *supra* for a discussion of vertical and horizontal interests in life estates.

[114]97 F.2d 701 (9th Cir. 1938).

[115]*See* text accompanying note 41 *supra* for a discussion of Blair v. Commissioner, 300 U.S. 5 (1937).

[116]Brook v. Commissioner, 360 F.2d 1011 (2d Cir. 1966); Rev. Rul. 73-428, 1973-2 C.B. 303. The franchise must also qualify as a capital asset under I.R.C. § 1221(1).

[117]307 F.2d 816 (4th Cir. 1962).

[118]*Id.* at 820.

[119]*Id.* at 819.

It is difficult to see why any distinction should be drawn between the initial payment and the subsequent payments. The fallacy of this bifurcated approach has been recognized in the mineral cases.[120] A single transaction either does, or does not, constitute a sale of the franchise. On facts similar to those of *Gowdey*, the Tenth Circuit held that all payments qualified for capital gain treatment.[121]

A Fifth Circuit case, *Moberg v. Commissioner*,[122] also involved transfers of Dairy Queen subfranchises. The consideration for each subfranchise consisted in part of $4,000, of which $2,000 was payable at closing with the balance to be paid at the rate of fifteen cents per gallon of mix used but not less than $1,000 per year. This part of the consideration would clearly have qualified for capital gain treatment. In addition, the franchiser was entitled to fourteen cents per gallon of mix used for as long as the franchise existed. The Tax Court had held all gain except that resulting from the sale of tangible assets to be taxable as ordinary income, not because of the royalty arrangement but because of the many restrictions and controls reserved by the taxpayer.[123] In the Tax Court's view, these restrictions and controls gave the taxpayer a continuing interest in how the franchised businesses were conducted, thereby making the transactions licensing arrangements rather than sales.[124] The Fifth Circuit reversed, noting that "these restrictions were consistent with a sale of the franchise to use the machine and trademark in an exclusive territory. The traditional test of ownership is the power to exclude others and that test was met here."[125]

The court of appeals held that the transaction constituted a sale but declined to characterize the royalties.[126] On remand, the Tax Court held that the franchises constituted capital assets in the hands of the taxpayer but that the royalty payments "did not represent a part of the sales price" and were therefore ordinary income.[127]

In a related case,[128] the Ninth Circuit agreed with the Fifth Circuit as to one form of the Dairy Queen subfranchise. Regarding a second form which imposed substantially greater restrictions on the franchisees, the Ninth Circuit found no sale and held all payments to be taxable as ordinary income. The distinguishing feature was that

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[120]*See* notes 82-87 *supra* and accompanying text; Consolidated Foods Corp. v. United States, 569 F.2d 436 (7th Cir. 1978).

[121]Dairy Queen v. Commissioner, 250 F.2d 5031 (10th Cir. 1957).

[122]305 F.2d 800 (5th Cir. 1962).

[123]Moberg v. Commissioner, 35 T.C. 773 (1961).

[124]*Id.* at 784.

[125]305 F.2d at 806.

[126]*Id.* at 784.

[127]Moberg v. Commissioner, 32 T.C.M. (P-H) ¶ 63,288, at 1680-63 (1963).

[128]Moberg v. Commissioner, 310 F.2d 782 (5th Cir. 1962).

those franchises which resulted in capital gain reserved to the franchiser controls which were designed primarily to assure that the agreed purchase price would be paid. Those franchises which resulted in ordinary income reserved to the franchiser more extensive power, including the power to make policy determinations about how the franchised operation should be conducted.

It is entirely appropriate to allow a franchiser to retain powers intended to protect the value and reputation of a trademarked product without disqualifying the franchise for capital treatment. In that respect, franchises are different from mineral rights and call for different rules of taxation. No apparent justification exists, however, for the difference in the treatment of royalty rights. If, as Supreme Court decisions have made clear, retention of a right to royalties based on production is incompatible with a transfer of all the risks and benefits of ownership and thus precludes a sale when transfer of a mineral interest is concerned,[129] the same result should obtain where a royalty right is retained in connection with granting a franchise.

This view draws some support from section 1253, adopted by Congress in 1969 in an attempt to clarify taxation of franchise transfers.[130] Under this provision, a transfer of a franchise will not be treated as the sale of a capital asset if the transferor retains any significant power, right, or continuing interest in the subject matter of the franchise. The statute specifies that a continuing interest includes a right to payments contingent on productivity if such payments constitute a substantial element under the transfer agreement, thereby contemplating an analysis identical to that developed by the courts in the oil, gas, and mineral cases. Those cases, however, have denied capital gain treatment without regard to whether retained royalty rights were substantial or insubstantial.[131] The question which arises is whether a sound basis exists for denying capital gain treatment to oil, gas, or mineral transactions when royalty rights are retained but denying it to franchise transactions only when substantial royalty rights are retained.

Some justification for this distinction is found in section 1253(c), which provides that contingent payments are taxable at ordinary rates even if the transaction qualifies as the sale of a capital asset. In other words, if the transferor of a franchise is to receive payments contingent on productivity which do not constitute a

[129]*See* notes 64-89 *supra* and accompanying text.

[130]Tax Reform Act of 1969, Pub. L. No. 91-172, § 516(c)(1), 83 Stat. 487.

[131]At least one court has suggested that a retained interest of insignificant value ought not characterize the entire transaction. Wood v. United States, 377 F.2d 300 (5th Cir. 1967).

substantial element under the transfer agreement, the transfer may be treated as a sale, but the contingent payments are nevertheless taxed at ordinary rates. Thus, section 1253 adopts a bifurcated approach which may result in part capital gain and part ordinary income treatment. Although the statute provides a more lenient standard than the oil, gas, and mineral cases in determining whether a sale of property has occurred, the tax effect of finding a sale under the statute is less significant. The bifurcated approach reduces the pressure on the sale versus license issue. Even if a sale has occurred, royalty income is taxed at ordinary rates. A similar statutory rule would be as desirable in the oil, gas, and mineral area as it is in the franchise area. It would prevent the characterization of an entire transaction by a retained royalty which may be an insubstantial part of the total consideration received.

B. *The Assignment of Income Doctrine*

No case has been found concerning the tax consequences of assigning a portion of a franchise by gift. Presumably, a vertical slice of a franchise could be effectively transferred. Thus, if one holds the right to make and sell Dairy Queen products in a five-state area, an unconditional assignment of the franchise pertaining to one of the states should be recognized for tax purposes.

If the donor retained some control over use of the franchise by the donee or assigned the franchise for a limited period of time, the issue would be whether the interest assigned was a mere right to income. If the interest transferred would have qualified for capital gain treatment had a transfer in exchange for a lump sum payment of cash occurred, the interest should be regarded as a gift of income-producing property with income subsequently produced taxed to the donee. On the other hand, if the donor retained control over operation of the franchised business, income may well be attributable to the continuing supervision of the donor and appropriately taxed to the donor.

VI. Contracts

A. *Capital Gain Versus Ordinary Income*

1. Service Contracts.—Courts have consistently denied capital gain treatment to income arising out of pure employment contracts.[132] As the Tax Court recently stated: "It is a well settled principle of law 'that consideration received for the transfer of a contract right

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[132]*See, e.g.*, Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962); Flower v. Commissioner, 61 T.C. 140 (1973); Heyn v. Commissioner, 39 T.C. 719 (1963); McFall v. Commissioner, 34 B.T.A. 108 (1936).

to receive income for the performance of personal services is taxable as ordinary income.'"[133] The principle applies equally to payments for cancellation of an employment contract not yet performed.[134]

In many instances, transactions will include not only cancellation or transfer of a service contract but also transfer of an interest in a number of other assets, tangible or intangible, some of which would yield capital gain if sold separately. Transactions of this kind have produced litigation and confusion.

In *Jones v. Corbyn*,[135] the taxpayer had an agency contract with an insurance company under which he had the exclusive right to solicit customers in the state of Oklahoma. When difficulties developed, the insurance company paid the taxpayer $45,000 in exchange for termination of the agency contract, all books, records, and files pertaining to the business, and rented office space from which the business had been conducted. The Commissioner argued that the agency contract was simply a right to perform services which would have generated ordinary income. The Tenth Circuit disagreed, concluding that the contract was a form of intangible property within the meaning of the capital gain provisions.[136]

In a subsequent case, *Elliott v. United States*,[137] the Tenth Circuit declined to follow its decision in *Jones v. Corbyn*, observing that the decision had been criticized by several courts and at least one commentator.[138] *Elliott* arose out of the merger of two insurance companies. The taxpayer had made an agreement with the surviving company to terminate his general agency contract with the merging company in exchange for nearly $50,000 plus a percentage of business produced under the contract prior to its termination. According to the termination agreement, the lump sum payment was for personal money invested in the business by the taxpayer. Nevertheless, the court held the $50,000 taxable as ordinary income, stating that personal money was expended by him to pay current operating expenses which he intended to recoup through com-

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[133]Goldman v. Commissioner, 44 T.C.M. (P-H) ¶ 75,138, at 628-75 (quoting Flower v. Commissioner, 61 T.C. 140, 148 (1973), *aff'd*, 50 F.2d 1302 (1974)) (lump sum received in exchange for release of all claims arising under partially performed employment contract held ordinary income).

[134]McFall v. Commissioner, 34 B.T.A. 108 (1936) (lump sum received by employee for cancellation of five-year employment contract with three years remaining held ordinary income).

[135]186 F.2d 450 (10th Cir. 1950).

[136]*Id.* at 452.

[137]431 F.2d 1149 (10th Cir. 1970). *See also* Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972).

[138]431 F.2d at 1154.

missions that would have been ordinary income.[139] Because the lump sum was received in exchange for relinquishing the right to earn ordinary income, application of the substitution doctrine was deemed appropriate.

A similar problem arose in the Fifth Circuit case of *Nelson Weaver Realty Co. v. Commissioner*.[140] A mortgage banking company had entered into a contract with a life insurance company for placing and servicing the insurance company's mortgage loans. Under the arrangement, the taxpayer agreed to make mortgage loans which it deemed to be sound and sell them to the insurance company as the permanent lender. For an agreed fee, the mortgage company collected periodic payments of principal and interest, arranged for payment of insurance and property taxes, and performed other routine services. This contract was assigned to another mortgage banker for $121,841. The assignee acquired all rights under the contract, including the right to service approximately 1,830 mortgages, and all business records pertaining to the contract. Although the Commissioner argued that the lump sum was a substitute for fees to be earned in the future which should be taxed as ordinary income, the court found no correlation between future income which would have been derived from servicing the loans and the purchase price. This lack of correlation and the fact that the taxpayer had transferred to the buyer business records which had been compiled over the years in connection with mortgage loans, including a customers list, persuaded the court to conclude that a longstanding relationship with a satisfied clientele, the equivalent of goodwill, had been sold. Accordingly, capital gain treatment was upheld.[141]

In *Weaver Realty*, the Fifth Circuit characterized the transaction as a whole. Because the consideration was not entirely a substitute for ordinary income, the court did not apply the substitution for income doctrine. This approach was promptly abandoned in *Bisbee-Baldwin Corp. v. Tomlinson*.[142] On facts similar to those involved in *Weaver Realty*, the court held that the proceeds were ordinary income to the extent attributable to servicing mortgage loans and capital gain to the extent attributable to goodwill or other valuable interests qualifying as capital assets.[143]

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[139] *Id.* at 1153.

[140] 307 F.2d 897 (5th Cir. 1962).

[141] *Id.* at 901.

[142] 320 F.2d 929 (5th Cir. 1963).

[143] *Id.* at 934-36. *See also* United States v. Wollsey, 326 F.2d 287 (5th Cir. 1963) (gain realized on sale of a business involving the management of mutual insurance companies taxed partly as ordinary income, partly as capital gain); United States v. Edison, 310 F.2d 111 (5th Cir. 1962) (gain realized on sale of an insurance business carried on under a general agency contract taxed at ordinary rates).

Finally, in *Flower v. Commissioner*,[144] the Fifth Circuit affirmed a Tax Court decision holding amounts received in exchange for termination of a selling contract to be ordinary income.[145] The taxpayer had received a lump sum payment for termination of a contract under which he was to promote and sell the products of a drug manufacturer. The taxpayer urged that he had disposed of assets other than the terminated contract, including goodwill, and that the sale price should be allocated among such assets with any gain attributable to capital assets taxed at capital rates. The court rejected this argument on the theory that any goodwill generated through the taxpayer's efforts attached to the manufacturer's products, not the taxpayer's business, and thus could not have been transferred by the taxpayer.[146] In addition, the court observed that the taxpayer did not transfer a franchise, he simply released a contract right to earn ordinary income, and that as a general principle consideration received for the transfer of a contract right to receive income for the performance of future services is taxable as ordinary income.[147]

As the foregoing cases demonstrate, the courts have employed property and agency laws in characterizing transactions which involve the disposition of service contracts plus other valuable rights. For example, in *Flower* the court emphasized that the taxpayer was the agent of another so that as a matter of law any goodwill or business records developed by the taxpayer did not belong to him but to his principal.[148] Thus, the taxpayer lacked a property interest to which a portion of the consideration could be allocated. In *Bisbee-Baldwin*, however, the taxpayer was accorded partial capital gain treatment because he had developed goodwill and business records under a contract as a nonagent.[149]

The distinction based on agency and property law is artificial and unpersuasive. The Supreme Court has frequently admonished that the answer to capital gain problems is not to be discovered in concepts of property law or other local law which may vary from state to state.[150] As a matter of substance, the taxpayers in all these

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[144]505 F.2d 1302 (5th Cir. 1974), *aff'g mem.* 61 T.C. 140 (1973).

[145]61 T.C. 140, 149 (1973), *aff'd mem.*, 505 F.2d 1302 (1974).

[146]*Id.* at 150.

[147]*Id.* at 151. *See, e.g.*, Furrer v. Commissioner, 45 T.C.M. (P-H) ¶ 76,331 (1976), 115 (9th Cir. 1977) (capital gain denied on facts similar to those in Flower).

[148]61 T.C. at 150.

[149]320 F.2d at 934.

[150]"It is the will of Congress which controls, and the expression of its will in legislation . . . is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. . . . State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent on state law." Burnet v. Harmel, 287 U.S. 103, 110 (1932) (citations omitted).

cases were doing business under a contract and were able to negotiate for a payment in exchange for relinquishing their contractual rights. Regardless of who owned the business records and goodwill, the taxpayer in each case was entitled to their use and benefit so long as the contract endured and was being compensated for the surrender of that valuable right. The fact that ordinary income would have been realized had the taxpayer continued to conduct business should not be controlling. One who sells inventory in the ordinary course of his business also earns ordinary income. That does not preclude capital gain treatment when the business is liquidated and the inventory sold in bulk. Similarly, the liquidation of valuable contractual rights should not preclude capital gain treatment merely because the rights would have produced ordinary income if retained.

For the same reasons, the pure employment contract cases[151] have not been decided on a principled basis. The absence of business records, goodwill, or some other property aside from the contract itself should not result in automatic denial of capital gain treatment. That amounts received in exchange for service contracts are substitutes for ordinary income should not be conclusive. The sale of inventory or the sale of stock for a price determined by expected dividends could also be described as a substitute for income.

It seems the assignment of income cases which flatly preclude the gratuitous assignment of earned income[152] have had an unfortunate impact here. Preserving the integrity of progressive taxation provides an adequate basis for an absolute prohibition on the assignment of income to be earned in the future by the assignor. That rationale does not extend to the capital gain area where one is giving up not only the right to receive income but also the right to earn future income. Following a gratuitous assignment of income, the assignor renders services but the assignee collects the income. Obviously, the assignor should be taxed. Similarly, if one sells his right to income from future services under an employment contract for a lump sum and thereafter renders the services with the assignee collecting the income, the assignor should be taxed at ordinary rates on the lump sum because it is a mere substitute for periodic payments. The employment contract continues to exist and the assignor continues to render services. But if more is involved—if all rights, including the right to render services under an employment

[151]*See* text accompanying notes 132-34 *supra.*

[152]*E.g.*, Lucas v. Earl, 281 U.S. 111 (1930). In what has become a famous metaphor, Justice Holmes declared he could think of no reason "by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115. The flat rule taxing all earned income to whoever earned it has endured. *See* United States v. Basye, 410 U.S. 441 (1973).

contract, are liquidated for a lump sum—a right to earn a flow of income in the future is exchanged for its present value, a transaction no different from any sale of income-producing property. In the final analysis, all income-producing property is equal to the present value of the future income it is expected to produce.[153] Thus, all sales of income-producing property involve the substitution of a lump sum for a flow of future income. Unless the substitution doctrine is limited to transactions not involving a termination of interest, it virtually swallows the capital gain provisions.

Furthermore, the substitution doctrine was developed to deal with transactions not involving a complete termination of interest because such transactions are outside the intended scope of the capital gain provisions. They do not involve the realization in a single year of the entire income the taxpayer will ever realize from the property. If a complete bunching of income occurs, as in the termination of an employment contract, the transaction is within the principal purpose of the capital gain provisions: to ameliorate the effect of progressive taxation on bunched income. Application of the substitution doctrine is incompatible with the purpose it was intended to serve. Finally, the Tax Court is incorrect in suggesting that *Lake* dictates ordinary income treatment whenever a lump sum payment is realized in lieu of periodic payments taxable at ordinary rates.[154] Capital gain treatment was denied in *Lake*, as in *Hort*, because income-producing property was not entirely disposed of. Under such circumstances the transferred interest was properly regarded as an income interest subject to the substitution doctrine. If a taxpayer with a ten-year employment contract sold the right to income for five years, the transaction would not be a termination of the employee's rights and duties under the contract but a mere collapsing of income and the *Lake* rationale should apply. However, the *Lake* rationale clearly should not control the cancellation of an employment contract which involves a complete termination of all economic interests in the contract. Under such circumstances, even-handed treatment of wage earners and property owners demands capital gain treatment for the termination payment except to the extent that it constitutes payment for past services.

[153]As graphically stated by the court in United States v. Dresser Indus., 324 F.2d 56 (5th Cir. 1963), "[t]he value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income." *Id.* at 59.

[154]In Flower v. Commissioner, 61 T.C. 140 (1973), the Tax Court found "strong support" in *Lake* for the following proposition: "[T]he consideration petitioner received for termination of his contract was a substitute for ordinary income he would have received had the contracts not been terminated, and nothing else. Thus, we conclude, the entire amounts received are taxable as ordinary income . . . ." *Id.* at 149.

2. Contracts Other than Service Contracts.—Contracts in which the rendition of services played a subsidiary role have fared only slightly better under the capital gain provisions. Many of the decisions turned on whether the contract right was regarded as "naked," or as a "substantial property right." Under this approach, contract rights qualify as a capital asset only if they create a direct interest in something conventionally regarded as property, such as a leasehold in real estate, or a life estate in a trust corpus consisting of securities.[155] Contracts which do not create such interests are said to be "naked" and therefore not property for purposes of the capital gain provisions.

The Second Circuit applied this analysis in *Commissioner v. Pittston Co.*,[156] characterizing as ordinary income a lump sum received by the taxpayer for release of its right to purchase all coal produced by a certain plant at eight percent below the market price.[157] The court stated that "[t]he courts have not been entirely consistent in their treatment of lump sum payments received by a taxpayer for the termination of jural relations . . . ."[158] Indeed, the Tax Court in *Pittston* had upheld capital gain treatment,[159] and Judge Moore, dissenting from the Second Circuit's decision, concluded that the "contract rights can only be rendered 'naked' by stripping from them and discarding the raiments which the parties found to be essential."[160]

One of the most carefully reasoned opinions in this area is *Commissioner v. Ferrer*.[161] The taxpayer had acquired the exclusive right to produce a stage play based upon a copyrighted novel, the power to prevent the sale of film rights in the novel for a specified period of time, and, if he in fact produced a play, the right to share in any proceeds subsequently generated through film rights. In exchange for cancellation of these contract rights, the taxpayer received a right to seventeen percent of the net profits realized from production of a movie. The Commissioner contended that the entire royalty was taxable at ordinary rates. The Second Circuit Court of Appeals reviewed the cases involving the tax treatment of amounts received

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[155]*See* Dorman v. United States, 296 F.2d 27 (9th Cir. 1961); Metropolitan Bldg. Co. v. C.I.R., 285 F.2d 592 (9th Cir. 1960); C.I.R. v. Golonsky, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

[156]252 F.2d 344 (2d Cir. 1958).

[157]*Id.* at 348.

[158]*Id.* at 347.

[159]Pittston Co. v. Commissioner, 26 T.C. 967, 969 (1956).

[160]252 F.2d at 349 (Moore, J., dissenting). *See* Commissioner v. Goff, 212 F.2d 875 (3d Cir. 1954) (surrender of contract rights to the entire product of four machines a capital gain transaction).

[161]304 F.2d 125 (2d Cir. 1962).

in exchange for contract rights and described the "naked" versus "substantial" analysis:

> One common characteristic of the group [of transactions] held to come within the capital gain provision is that the taxpayer had either what might be called an "estate" in . . . or an "encumbrance" on . . . or an option to acquire an interest in . . . property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another . . . or by rendering services . . . or by virtue of ownership of a larger "estate."[162]

Accepting this analysis, the court categorized the various interests held by the taxpayer as either capital gain or ordinary income by examining the character of the transaction.[163] The court noted that the play production right "sounds like the transactions held to qualify for capital gain treatment."[164] The court theorized that the interest resembled a lease or an equitable interest, which is more than a contract right to earn income by rendering services.[165] In addition, the court observed that the production right is intimately related to the copyright of the play, which is a capital asset.[166] The court thus rejected the Commissioner's substitution for income argument, stating that payment in exchange for relinquishment of the right to produce a play could qualify for capital gain even though exercise of the right would have generated ordinary income.[167]

Similarly, the court decided that the taxpayer's right to prevent the sale of motion picture rights for a specified period of time constituted an equitable interest in the author's copyright over motion picture rights.[168] The court held that relinquishment of that interest should be taxed at capital gain rates,[169] producing the same result as

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[162]*Id.* at 130-31 (citations omitted).

[163]The court rejected the wholly unsatisfactory approach it had taken earlier in Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953), and General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953). In these cases, the court had focused upon whether the interests relinquished had survived the transaction, thereby meeting the sale or exchange requirement, or had been extinguished. This approach would seldom result in capital gain treatment upon cancellation of a contract because the interests are normally extinguished. As the *Ferrer* court recognized, the parties to the transaction generally will "not care a fig whether there was an 'annulment or conveyance.'" 304 F.2d at 131.

[164]304 F.2d at 131.

[165]*Id.* at 132.

[166]For a more recent application of the same analysis, *see* Crisp, 42 T.C.M. (P-H) ¶ 73,006 (1973).

[167]304 F.2d at 132.

[168]*Id.* at 133.

[169]*Id.*

the transfer of the entire copyright, rather than a limited interest relating to the copyright. When considering the right to share in profits derived from the sale of movie rights, the court reached the opposite result. The contract provided that the taxpayer was to have "no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive"[170] a share of the proceeds. Because the author expressly retained all property rights relating to producing a motion picture, the taxpayer had nothing more than a right to a share of future income which would have been taxed at ordinary rates. Relying on *Hort* and the substitution for income arguments, the court held that the amounts received in exchange for release of the percentage rights constituted ordinary income.[171]

In deciding the tax treatment of gains from the sale of covenants not to compete, the courts have relied upon property law concepts. In the words of the Second Circuit:

> It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor and an amortizable item for the covenantee unless the covenant is so closely related to a sale of good will that it fails to have any independent significance apart from merely assuring the effective transfer of that good will.[172]

Thus, the capital gain treatment depends on the relationship of the covenant to some other item, usually goodwill, conventionally recognized as a property interest. It is difficult to conceive how a covenant not to compete given by the seller of a business can be anything but ancillary to the sale of business assets.[173] Nonetheless, many cases have denied capital gain treatment on the theory that the covenant was severable from the sale of other assets.[174] If the covenantor is a shareholder in the corporation which sold business assets, capital gain treatment has generally been denied on the grounds that the covenantor sold no assets to which the covenant could be ancillary.[175] This result, grounded on the corporate law concept of the corporation as a separate entity, ignores the economic

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[170] *Id.* at 134.

[171] *Id.*

[172] Ullman v. Commissioner, 264 F.2d 305, 307-08 (2d Cir. 1959).

[173] *See* 3B J. Mertens, Law of Federal Income Taxation § 22.33, at 297 (1977).

[174] *See, e.g.*, Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964).

[175] Montesi v. Commissioner, 340 F.2d 97 (6th Cir. 1965); Hamlin Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954).

unity of the corporation's business and the shareholder's business which made the shareholder covenant necessary. Stripped of its technicalities, most would agree the result is unfortunate.[176]

The answer to capital gain issues should not be sought in the law of corporations any more than in the law of property or agency. The convoluted reasoning of the lower courts has led to conflicting and inappropriate results and has increased tremendously the complexity of the characterization process. Proper analysis would follow the simpler lines of *Hort* and *Lake*. If there were a complete disposition of whatever valuable rights the taxpayer owned, the transaction would fall within the intended scope of the capital gain provisions.[177] If the disposition were incomplete, there would be no sale of property rights, merely an arrangement for their exploitation.

Under the termination of interest test, the result of many of the cases considered above would be altered. For example, the taxpayer in *Pittston Co.* liquidated its entire contract right for a specified sum of money and would qualify for capital gain treatment under the termination of interest test. To deny capital gain treatment for such a transaction when the liquidation of other forms of valuable interests qualify, is arbitrary and unfair. In *Ferrer* the taxpayer held three contract rights, one relating to production of a stage play and two relating to production of a motion picture. Only the first was liquidated and only it should have qualified for capital treatment. The taxpayer, in effect, exploited the other contract rights by relinquishing them in exchange for a share of profits realized from production of a movie. On the other hand, covenants not to compete would generally qualify for capital treatment since they normally involve a complete relinquishment of the right to compete during the term of the covenant—the covenantor's consideration is not usually dependent upon the covenantee's profits.

B. Assignment of Income Doctrine

Rights and duties under a personal service contract cannot be assigned by gift. One can assign the right to collect payments for the rendition of services, but the assignment is ineffective for tax purposes. The assignor will be responsible for the taxes on any income earned by his services even though the income is collected by

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[176]*See* 3B J. MERTENS, *supra* note 173, at 300.

[177]Of course, limitations unrelated to those discussed here may preclude capital gain treatment. *See, e.g.*, Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955) (transactions which are an integral part of a trade or business do not qualify for capital gain treatment).

the assignee.[178] This practice is consistent with ordinary income treatment for any lump sum received in lieu of periodic payments for past or future services.[179]

Contracts which do not involve the retention of services by the transferor should be freely assignable by gift for income tax purposes, subject to the usual termination of interest rule. Even a contract right productive of ordinary income in the hands of the donor should be assignable. Such treatment is consistent with the *Blair* ruling concerning an assignment of a life estate[180] and should not depend on whether the contract right is deemed "naked" or "substantial." The "naked" versus "substantial" test is irrelevant to the purpose of the assignment of income doctrine which prevents frustration of progressive taxation by splitting income among taxpayers. No splitting of income occurs when one transfers his entire interest. The donee may be in a lower tax bracket than the donor, but no sound reason exists for precluding assignment of an entire contract right to a low-bracket donee while permitting assignment of other income-producing property to such a donee. Nevertheless, the courts are likely to apply the analysis of *Pittston*, *Ferrer*, and the covenant-not-to-compete cases. If the courts adopt this approach, assignability would depend on the "naked contract" versus "substantial property interest" test.[181]

VII. Conclusion

Equity and simplicity should be goals of any area of the law. Although not mutually exclusive, the two concepts often clash. If capital gains were taxed at the same rates as ordinary income, simplicity would be achieved but inequities created because gains accumulated over a period of years would be taxed in a single year according to a progressive rate structure. Thus, equity may require a certain degree of complexity.

The Supreme Court's decisions provide a coherent theory in which transfers of income-producing interests are recognized for capital gain and assignment of income purposes if the transfer terminates the taxpayer's interest in the transferred property. This theory is not only easy to understand and apply, but also is consistent with the underlying purposes of capital gain treatment and the assignment of income doctrine. If one has not terminated his interest in property, all income to be realized from the property is not assessed in a single year, and capital gain treatment is appropriately

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[178]Lucas v. Earl, 281 U.S. 111 (1930).

[179]*See* text accompanying note 152 *supra*.

[180]*See* text accompanying note 41 *supra*.

[181]The author has found no cases involving gifts of this interest.

withheld. Similarly, transfer by gift of less than one's entire interest in property results in a splitting of income between donor and donee. The transfer should be disregarded to preserve the integrity of the progressive rate structure. The termination of interest rule produces equitable results if applied uniformly without regard to the nature of the property in question.

Lower court decisions are another matter. In dealing with certain types of property interests, such as franchises and contractual rights, which the Supreme Court has not considered specifically, the lower courts have applied ambiguous and specious standards in construing the capital gain provisions. They have made the relatively simple process of characterizing a transaction for capital gain or assignment of income purposes, complicated, speculative and, to a large degree, unpredictable. Furthermore, the selection of different standards for different types of interests ignores equitable concerns. Arbitrary distinctions have led to arbitrary and inequitable results. Simplicity and equity need not be sacrificed if the lower courts adopt the guiding principles of *Hort*, *Blair*, *Lake*, and other Supreme Court decisions.

When Does A Limited Partnership Possess the Corporate Characteristic of Limited Liability?

*Ralph C. Anzivino**

I. Introduction

The Internal Revenue Code (IRC) places various organizations, including associations which are taxable as corporations, partnerships, and trusts, into specific categories for purposes of taxation and prescribes the standards applicable for determining whether an organization belongs in a particular category.[1] Four major characteristics must be considered when distinguishing between an association and a partnership: "centralization of management, continuity of life, free transferability of interests, and limited liability."[2] If an organization possesses more corporate than noncorporate traits, the Internal Revenue Service (IRS) will not treat the organization as an association.[3] Continuity of life, centralized management, and free transferability of interests are readily identifiable corporate characteristics which have not caused the courts or the IRS great concern.[4] On the other hand, limited liability is a characteristic which has created significant consternation.[5]

Ordinarily, if state law provides that a member of an organization is not personally liable for organizational debts, then the organization possesses the corporate trait of limited liability.[6] A member is personally liable if "a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim."[7]

The liability of a general partner in a limited partnership depends on the amount of assets subject to creditor claims and the extent of the general partner's independence from control by the limited partners. Formation of an organization as a limited partner-

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*Assistant Professor of Law, Marquette University Law School. J.D., Case Western Reserve School of Law, 1971.

[1]I.R.C. § 7701; Treas. Reg. § 301.7701(b), T.D. 6503, 1960-2 C.B. 412.

[2]*Id.* § 301.7701-2(a)(2).

[3]*Id.* § 301.7701-2(a)(3).

[4]*See* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976); Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942).

[5]*See* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976); Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942).

[6]Treas. Reg. § 301.7701-2(d)(1), T.D. 6503, 1960-2 C.B. 412.

[7]*Id.*

ship[8] contemplates that the general partner will have personal liability.[9] A corporation possessing limited liability may be a general partner of a limited partnership.[10] The corporation's personal liability as a general partner may depend on whether the corporation has substantial assets which partnership creditors can reach.[11] The corporation's contribution of services instead of cash or property to the limited partnership will not excuse the corporation from personal liability, provided the corporation has substantial assets.[12] Even if the corporate general partner does not have substantial assets subject to the creditors' claims, the corporation still may have personal liability when it "is not merely a 'dummy' acting as the agent of the limited partners."[13] The synthesis of the above propositions provides the following rule: If an organization is created as a limited partnership, a general partner is not personally liable when it does not have substantial assets that can be reached by the creditors *and* when it "is merely a 'dummy' acting as the agent of the limited partners."[14] In other words, an organization has the corporate characteristic of limited liability whenever the IRS finds that the organization is not personally liable because the general partner lacks substantial assets *and* acts as a dummy for the limited partner. Both the "substantial assets" and "dummy" determinations raise serious problems of interpretation which this Article resolves.

II. "Dummy" Concept

As previously stated, a general partner in a limited partnership that lacks substantial assets can still qualify as a bona fide general partner with personal liability, provided the general partner is not a "dummy" for the limited partners.[15] Defining a dummy, however, is a highly controversial problem. In 1977, the United States Treasury Department unsuccessfully attempted to remove the concept from its regulations.[16] The Treasury Department's failure means that the dummy concept will remain in the tax regulations for the foreseeable future, thereby requiring the adoption of a workable definition.

The dummy concept was derived from *Glensder Textile Co. v.*

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[8]For a discussion of some of the considerations in forming a limited partnership, see J. Crane & A. Bromberg, Law of Partnership § 26, at 143-46 (1968).

[9]*See* Uniform Limited Partnership Act §§ 1, 9 (1916).

[10]J. Crane & A. Bromberg, *supra* note 8, § 26, at 146-47.

[11]Treas. Reg. § 301.7701-2(d)(2), T.D. 6503, 1960-2 C.B. 412.

[12]*Id.*

[13]*Id.*

[14]*Id.*

[15]*Id.*

[16]42 Fed. Reg. 1039-44 (1977) (withdrawn at 42 Fed. Reg. 1489 (1977)).

Commissioner.[17] In *Glensder*, which arose under an earlier version of the current tax regulations, the Board of Tax Appeals held that for purposes of taxation the organization in question resembled an ordinary partnership rather than a corporation.[18] The board in *Glensder* made the following observation about the dummy concept:

> Even within the form of limited partnership most generally known, in which general and limited partners are associated together, we may still suppose situations where the resemblance to corporate form would be so substantial as to justify classification of the limited partnerships as corporations. If, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors. But, as a practical matter, to suppose such a situation we must also suppose that the limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners.[19]

The language from *Glensder* suggests that a dummy is a partner without substantial assets who acts as an agent of the limited partners.[20] The regulations, however, adopted a conjunctive test for limited liability of a general partner: The general partner does not have personal liability when it lacks substantial assets and merely acts as a dummy agent for the limited partners.[21] The IRS, therefore, intended the "dummy" concept to mean more than a partner lacking any substantial assets.

The most important development in this area of the law since the adoption of the current regulations is the Tax Court's decision in *Larson v. Commissioner*.[22] In *Larson*, the Tax Court decided that the organization under scrutiny should be treated for tax purposes as a limited partnership.[23] More important, the Tax Court provided three standards for determining whether the general partner is a dummy. First, the court suggested that a general partner which is "totally

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[17] 46 B.T.A. 176 (1942).
[18] *Id.* at 187.
[19] *Id.* at 183.
[20] *See also* 66 T.C. at 180-81.
[21] Treas. Reg. § 301.7701-2(d)(2), T.D. 6503, 1960-2 C.B. 412.
[22] 66 T.C. 159 (1976).
[23] *Id.* at 185.

under the control" of the limited partners may be a dummy.[24] Second, the court suggested that a general partner may qualify as a dummy when the limited partners are empowered to direct the business actively through the general partner.[25] Third, the court stated that a general partner which is used as a screen to conceal the limited partner's "active involvement" in the conduct of the business may be a dummy.[26] Although the court did not indicate the need to distinguish among the various tests, this Article will establish the critical need to identify certain differences.

In 1979, the IRS acquiesced in the *Larson* decision.[27] Acquiescence in a decision means that the IRS accepts the conclusion reached by the court but "does not necessarily mean acceptance and approval of any or all of the reasons assigned by the [c]ourt for its conclusions."[28] The IRS acquiescence, therefore, indicates that the reasoning of the *Larson* court on the dummy issue is not necessarily accepted or approved by the Service. In fact, the Service warned that "caution should be exercised in extending the application of *Larson* to a similar case, unless the facts and circumstances are substantially the same."[29] Also, the IRS has indicated that consideration should be given to the effect that "new legislation, regulations, and rulings as well as subsequent court decisions" will have on *Larson.*[30] On the same day as the *Larson* acquiescense, the IRS issued Revenue Ruling 79-106,[31] which derives from *Larson* and identifies certain factors that have a bearing on the four[32] major corporate characteristics that determine the classification of an arrangement formed as a limited partnership. The IRS' acquiescence in *Larson* and the issuance of Revenue Ruling 79-106 are subtle efforts to provide a workable definition of "dummy."

Rather than acquiesce in *Larson*, the IRS could have acquiesced in *Zuckman v. United States*,[33] which also dealt at length with the dummy issue.[34] The court's holding in *Zuckman* equated the general

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[24] *Id.* at 181. Although some control may be vested in the limited partners, total control by the limited partners turns a general partner into a dummy. *Id.*

[25] *Id.*

[26] *Id.*

[27] 1979-1 C.B. 1.

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] Rev. Rul. 79-106, 1979-1 C.B. 448.

[32] Because associates and the object of carrying on business for joint profit are essential characteristics of all organizations engaged in business for profit, those two characteristics are generally ignored, thereby leaving only four basic ones. *See* Treas. Reg. § 301.7701-2(a)(2) (1965).

[33] 524 F.2d 729 (Ct. Cl. 1975).

[34] *Id.* at 740-42.

partner's status as a dummy with the limited partner's "control" under section 7 of the Uniform Limited Partnership Act (U.L.P.A.).[35] The net effect of such a holding is to render the tax regulations on limited liability meaningless. If a court rules that a general partner is a dummy, then the limited partners have personal liability under section 7, according to *Zuckman*. Conversely, if a court rules that a general partner is not a dummy, then the general partner is personally liable. In either event, some member or members of the limited partnership will have personal liability; thus, the IRS under the reasoning of *Zuckman* could never establish the limited liability characteristic. Had the IRS acquiesced in *Zuckman*, then the tax regulations as they relate to dummy partners would be entirely useless. Some respected jurists believe that the court's holding in *Larson* on the dummy issue has the same effect as *Zuckman* in rendering the regulations meaningless.[36] Nevertheless, the tax regulations on limited liability do not have to be meaningless if the proper choice is made among the various tests in *Larson* for establishing dummy status.

Obviously, the interplay between a limited partner's section 7 liability and the limited partner's ability to transform a general partner into a dummy by the control exercised over the general partner must be reconciled. The failure to reconcile these two concepts would result in hopelessly circular regulations.[37]

The task of reconciling these factors first requires a determination of the amount of control necessary to cause a limited partner to be deemed personally liable under section 7. Section 7 provides that "[a] limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."[38] The failure to define what constitutes "taking part in the control of the business" is considered to be the greatest drawback to the limited partnership form of operation.[39] Although the statute and decisions dealing with section 7 do not decisively define "taking part in control of the business," a number of courts and scholars have reached

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[35]*Id.* at 741. Hereinafter, UNIFORM LIMITED PARTNERSHIP ACT § 7 (1916) will be referred to as § 7.

[36]*See* Larson v. Commissioner, 66 T.C. at 188-90 (Dawson, C.J., concurring); *id.* at 205-06 (Quealy, J., dissenting).

[37]Equating a general partner's status as a "dummy" with the control that the limited partners have in the partnership not only violates § 7 but also results in some members of the partnership always being personally liable; therefore, the IRS could never establish the corporate characteristic of limited liability under the *Zuckman* rule.

[38]UNIFORM LIMITED PARTNERSHIP ACT § 7 (1916).

[39]J. CRANE & A. BROMBERG, *supra* note 8, § 26 at 147-48.

a general consensus about the meaning of the section 7 phrase. A limited partner may be personally liable to the creditors of the partnership under section 7 when the limited partner assumes the day-to-day control of the partnership.[40] In *Delaney v. Fidelity Lease Ltd.*,[41] the plaintiffs brought an action for breach of lease against a limited partnership, the sole corporate general partner, and the limited partners. The limited partners had dual capacities in that they were also officers of the sole corporate general partner. The limited partners in their officer roles conducted the day-to-day business of the partnership. Recognizing the difficulty of separating the acts of the limited partners into different categories, the Texas Supreme Court concluded that their day-to-day control as limited partners violated section 7.[42]

A limited partner may also violate section 7 by exercising some fairly broad powers of control over the partnership. In *Holzman v. De Escamilla*,[43] the limited partners violated section 7 because they decided what crops to plant and controlled withdrawals from the partnership's checking account.[44] Although the limited partner's actions did not constitute "day-to-day" activities, they did constitute sufficient participation in the business to violate section 7. A limited partner's "active participation" in the business not only violates section 7 but also causes a limited partner to become personally liable as a general partner.

A number of courts require more than "active participation" by a limited partner to impose personal liability under section 7.[45] These cases require active participation *plus* a showing that the creditors detrimentally relied on the belief that the limited partner was actually a general partner.[46] The genesis for this approach to section 7 liability is premised on a basic assumption of the U.L.P.A.:

> No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligations of the business; provided

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[40]Weil v. Diversified Properties, 319 F. Supp. 778 (D.D.C. 1970); Gast v. Petsinger, 228 Pa. Super. Ct. 394, 323 A.2d 381 (1974).

[41]526 S.W.2d 543 (Tex. 1975).

[42]*Id.* at 545.

[43]86 Cal. App. 2d 858, 195 P.2d 833 (1948).

[44]*Id.* at 860, 195 P.2d at 834.

[45]*See, e.g.*, Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244 (1977); Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757 (1950).

[46]Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244; Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757.

creditors have no reason to believe at the times their credits were extended that such person was so bound.[47]

In *Frigidaire Sales Corp. v. Union Properties, Inc.*,[48] a creditor of a limited partnership brought a claim against the corporate general partner and the limited partners individually for failure to pay an installment payment due on a contract. The Washington Supreme Court held that the limited partners were not personally liable, absent a finding that the creditor relied on the credit of the limited partners when extending credit to the partnership.[49] A majority of state statutes are silent on whether reliance is a necessary element of section 7 control.[50] The 1976 Revised U.L.P.A. implicitly states that reliance is intended to be a part of the section 7 determination.[51] The 1976 version, however, has not been adopted in any state.

Judicial decisions interpreting the statute indicate that when a limited partner actively participates in the business it violates section 7 and becomes personally liable. Active participation can vary from making day-to-day decisions dealing with all organizational matters to periodic decisions relating only to major items. In addition to active participation, some courts have required that the creditor prove reliance as a necessary part of the section 7 test. Under either judicial standard, the limited partner must do more than possess the power to control[52] the general partner to violate section 7. No commentator or court has suggested that mere possession of the power to control should result in imposing personal liability on the limited partner. If active participation satisfies the element of control for section 7, any quantum of control *less than* section 7 control by a limited partner should constitute sufficient authority to convert the general partner into a dummy. Logically, a limited partner that possesses the power to control but does not exercise such authority to actively participate in the business or to cause creditor reliance should *not* be held personally liable under section 7. Nevertheless, a limited partner's possession of the power to control should convert the general partner into a dummy, even

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[47]Uniform Limited Partnership Act § 1, Official Comment (1916).

[48]88 Wash. 2d 400, 562 P.2d 244 (1977).

[49]*Id.* at 406, 562 P.2d at 247.

[50]Only Alabama and Delaware have expressly included reliance as an element of § 7 control. Ala. Code tit. 10, § 10-9-41 (1975); Del. Code tit. 6, § 1707 (1974).

[51]*See* Revised Uniform Limited Partnership Act § 303(a) (1976).

[52]This author uses "power to control" to mean that the limited partners arguably may possess certain rights by virtue of the partnership agreement to control the policies and decisions of the partnership. Such rights could be the power to remove the general partner, dissolve the partnership, approve or disapprove the sale of all or substantially all of the assets of the partnership, and amend the partnership agreement.

though the limited partner is not personally liable under section 7. The power to control or empowerment standard merely suggests that one consider the quantum of control that limited partners have over general partners by virtue of certain rights granted in the partnership agreement or certificate. The important rights include the powers to remove the general partner, dissolve the partnership, approve or disapprove the sale, lease, exchange, or mortgage, pledge all or substantially all of the partnership assets, and amend the partnership certificate.

Substantial support exists for defining "dummy" according to the power to control or empowerment standard. The Board of Tax Appeals in *Glensder* indicated that the general partners were dummies because the "limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners."[53] In *Larson*, the Tax Court indicated that a general partner could qualify as a dummy if the limited partners totally controlled the general partner[54] or if the partnership agreement empowered the limited partners to control the business actively through the general partner.[55] The *Larson* court also suggested a third test: A general partner is a dummy if the general partner is used as a screen to conceal the "active involvement" of the limited partners in the conduct of business.[56] Unfortunately, this third test causes confusion because it goes beyond "control" or the "power to control" to require "active involvement" or "participation," thereby violating the section 7 standard for imposing personal liability. Nevertheless, two of three definitions extracted from *Larson* support the "power to control" test. The IRS could easily argue in future cases that their acquiescence in *Larson* only involved the "power to control" definition rather than the "active participation" definition of dummy.

The limited partner's control over a dummy general partner has been likened to a shareholder's control in a corporation.[57] The analogy is not legally correct. The United States Treasury Regulations clearly indicate that a general partner which is a dummy for the limited partners is also an agent acting for its principal.[58] The directors of a corporation are fiduciaries and are not agents of the shareholders because the directors have no obligation to respond to the shareholders concerning the details of management.[59] Albeit the

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[53]46 B.T.A. at 183.

[54]66 T.C. at 181.

[55]*Id.*

[56]*Id.*

[57]46 B.T.A. at 183. *See also* Larson v. Commissioner, 66 T.C. at 197 (Simpson, J., dissenting).

[58]Treas. Reg. § 301.7701-2(d)(2) (1965).

[59]Restatement (Second) of Agency § 14, Example c (1958).

analogy is not legally correct, the analogy is at least useful to exemplify those powers which give the limited partners control over a general partner, thereby converting the general partner into a dummy. The traditional powers that the shareholders possess over the directors of a corporation are the powers to remove directors,[60] dissolve the corporation,[61] approve or disapprove the sale of all or substantially all of the assets of the corporation,[62] and amend the articles of incorporation.[63] A limited partner's possession of such powers is not sufficient to cause a limited partner to be personally liable under section 7.[64] In fact, the 1976 Revised U.L.P.A. proposes that limited partners can be vested with such powers without causing personal liability.[65] Ergo, the limited partner's possession of such powers should be sufficient to convert the limited partnership's general partner into a dummy for purposes of the tax regulations but should not cause personal liability for the limited partner pursuant to section 7.

The question can be asked fairly whether the limited partners can have *any* power of control over the general partner without converting him into a dummy. The Treasury Regulations provide that in the case of a limited partnership subject to a statute corresponding to the U.L.P.A.,[66] each general partner may be personally liable.[67] In other words, if limited partners only possess those powers of control which are sanctioned by the Act, then the general partner will not be deemed a dummy. The limited partner's power of control over a general partner is defined in sections 9 and 10 of the Act.[68] The most

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[60] ABA-ALI MODEL BUS. CORP. ACT § 39 (1969).

[61] *Id.* § 83.

[62] *Id.* § 79.

[63] *Id.* § 59.

[64] An analysis of the § 7 cases indicates that *at least* "active involvement" by a limited partner is required for imposing personal liability. Therefore, simply possessing certain powers would not cause personal liability.

[65] UNIFORM LIMITED PARTNERSHIP ACT § 303 (1976 version).

[66] The Treasury Regulations do not refer to the 1976 amendments made to the U.L.P.A. because the regulations were adopted prior to any amendments to the Act.

[67] Treas. Reg. § 301.7701-2(d)(1) (1965). The argument can be made that subparagraph (d)(1), which contains the U.L.P.A. reference, refers to subparagraph (d)(2), which contains the "dummy" language, and that a "dummy" therefore could exist even under a U.L.P.A. partnership. *Glensder* also arguably supports this argument because the court stated that "even within the form of limited partnership most generally known, in which general and limited partners are associated together, we may still suppose situations in which the resemblance to corporate form would be so substantial as to justify classification of the limited partnerships as corporations." 46 B.T.A. at 183.

[68] The UNIFORM LIMITED PARTNERSHIP ACT §§ 9-10 (1916) provide:

§ 9. Rights, powers and liabilities of a general partner

(1) A general partner shall have all the rights and powers and be sub-

significant powers granted to the limited partners are the powers to dissolve and to approve or disapprove the admission of a new general partner.[69] Any powers granted in the certificate or partnership agreement to the limited partners to control the general partner beyond those sanctioned by sections 9 and 10 of the Act seriously increase the possibility that the IRS will categorize the general partner as a dummy. Essentially, one would be in "uncharted waters." The only indication that some nonsanctioned powers may be included in the partnership agreement is the language from *Larson* which permitted the limited partner to have the power of removal over the general partner without converting the general partner into a dummy.[70] Yet, the IRS' recent pronouncement in Revenue Ruling 79-106 indicated that the limited partner's right or *lack* of right to vote on the removal and election of general partners will have significance in determining the limited liability characteristic. Thus, reliance on *Larson* for this point may be risky. The IRS also considers that the limited partner's right or *lack* of right to vote on the sale of all or substantially all of the assets of the partnership will be important in determining limited liability. Conse-

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ject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to

(a) Do any act in contravention of the certificate,

(b) Do any act which would make it impossible to carry on the ordinary business of the partnership

(c) Confess a judgment against the partnership,

(d) Possess partnership property, or assign their rights in specific partnership property, for other than a partnership purpose,

(e) Admit a person as a general partner,

(f) Admit a person as a limited partner, unless the right to do so is given in the certificate,

(g) Continue the business with partnership property on the death, retirement or insanity of a general partner, unless the right to do so is given in the certificate.

§ 10. Rights of a limited partner

(1) A limited partner shall have the same rights as a general partner to

(a) Have the partnership books kept at the principal place of business of the partnership, and at all times to inspect and copy any of them,

(b) Have on demand true and full information of all things affecting the partnership, and a formal account of partnership affairs whenever circumstances render it just and reasonable, and

(c) Have dissolution and winding up by decree of court.

(2) A limited partner shall have the right to receive a share of the profits or other compensation by way of income, and to the return of his contribution as provided in sections 15 and 16.

[69] *Id.* §§ 9(e), 10(c).

[70] 66 T.C. at 181.

quently, the best advice is to stay within the "safe harbor" of the U.L.P.A.'s sanctioned powers.

Reliance on the power-to-control test will have serious consequences for states that adopt the Revised U.L.P.A. or various state blue sky regulations dealing with real estate programs. The impact on the Revised U.L.P.A. is clear. The greater powers granted to limited partners[71] are specifically the types of powers that will convert the general partner into a dummy under the tax regulations. Possession of these powers under the 1976 Act will automatically clothe the organization with the corporate characteristic of limited liability if the general partner is also without substantial assets.[72] In sum, the dummy issue would disappear if a partnership incorporated the greater powers provided in the Act. Obviously, the problem of defining a "dummy" is a deterrent to the adoption of the Revised Act.

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[71]The 1976 Revised UNIFORM LIMITED PARTNERSHIP ACT provides:

§ 303. Liability to Third Parties

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

(1) being a contractor for or an agent or employee of, the limited part nership or of a general partner;
(2) consulting with and advising a general partner with respect to the business of the limited partnership;
(3) acting as surety for the limited partnership;
(4) approving or disapproving an amendment to the partnership agreement; or
(5) voting on one or more of the following matters:
(i) the dissolution and winding up of the limited partnership;
(ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business;
(iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
(iv) a change in the nature of the business; or
(v) the removal of a general partner.

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him in the business of the limited partnership.

[72]The second part of the writing suggests that the substantial assets requirement can be reasonably identified and complied with to avoid the difficult issue of determining "dummy status."

Use of the power-to-control standard will also affect limited partnerships in states which have adopted certain blue sky regulations. The Midwest Securities Commissioners Association[73] statement of policy regarding real estate programs mandates that

> [t]o the extent the *law of the state in question is not inconsistent*, the limited partnership agreement *must* provide that a majority of the then outstanding limited partnership interests may, without the necessity for concurrence by the general partner, vote to (1) amend the limited partnership agreement, (2) dissolve the program, (3) remove the general partner and elect a new general partner, and (4) approve or disapprove the sale of all or substantially all of the assets of the program.[74]

Obviously, if a state adopts the Revised U.L.P.A., these four rights are mandatory. The Central Securities Administration Council[75] identifies four similar rights[76] and states that these rights should be included in the partnership agreement, provided the limited partners are not exposed to personal liability as a result of such a grant.[77] Clearly, both governing groups focus primarily on only state law as determining whether such broad powers should be given to the limited partners. This approach is not well conceived. The commissioners' definitions automatically convert the partnerships into "dummies" by requiring those greater powers without reference to the tax impact. The only tax consideration provided in the regulations of the Midwest Securities Commissioners Association is that the limited partnership either have a favorable tax ruling from the IRS or an opinion of counsel that the partnership will be taxed as a partnership and not as an association.[78] Certainly, the performance of this task is made more difficult by the failure of the blue sky laws to consider the tax effect of mandating the inclusion of such powers or rights in the partnership agreement.

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[73]A recent listing of member states included: Alabama, Arizona, Arkansas, California, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming. [1976] 1 BLUE SKY L. REP. (CCH) ¶ 4721, at 551. Since the list was compiled, Alaska and Florida have become members. This information is based on contacts with the securities offices of those states.

[74][1976] 1 BLUE SKY L. REP. (CCH) ¶ 4821, at 645-3 (emphasis added).

[75]Member states are Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, and Wisconsin. *Id.* ¶ 4877, at 687.

[76]*Id.* ¶ 4877, at 693.

[77]*Id.*, at 694.

[78]*Id.* ¶ 4821, at 657.

III. Substantial Assets Concept

Because the limited liability test is conjunctive,[79] a showing that the general partner has substantial assets preserves the personal liability attribute of the limited partnership.[80] Clearly, the general partner's equity position in the limited partnership should not be considered in the substantial assets determination.[81] Further, the quantum of assets owned by the general partner may still be considered to be substantial even though the "assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization."[82]

The IRS has guidelines to measure the substantiality of a general partner's assets or net worth.[83] Revenue Procedure 72-13 provides the following methods of calculation:

> .02 If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than $2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or $250,000, whichever is the lesser; if the total contributions to that partnership are $2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions. In computing the net worth of the corporate general partner, for these purposes, its interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership will be excluded.
>
> . . . .
>
> .04 For purposes of computing the net worth of the corporate general partner in .02 and .03 above, the current fair market value of the corporate assets must be used.[84]

The United States Treasury, however, does not have any guidelines to measure the substantiality of assets when the general partner is an individual or entity other than a sole corporation.[85] The simple answer to this problem would be to apply by analogy the sole

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[79] *See* Treas. Reg. § 301.7701-2(d)(2) (1965).

[80] *Id.* A showing that a general partner has substantial assets forecloses any inquiry into the more troublesome "dummy" issue.

[81] *See id.*

[82] *Id.*

[83] Rev. Proc. 72-13 § 2.02, .04, 1972-1 C.B. 735.

[84] *Id.*

[85] For purposes of clarity, the author will use the word "individual" to include individuals and entities other than a sole corporation when discussing the "substantial assets" test.

corporate general partner net worth requirements to all general partners. Such high net worth requirements for individuals, however, unnecessarily focuses on capital. The regulations provide that "an organization has the corporate characteristic of limited liability *if under local law* there is no member who is personally liable for the debts of or claims against the organization."[86] When the organization is a limited partnership, one of the determinations which must be made under *local law* is whether the general partner has substantial assets.[87] In the case of a sole general corporate partner, the Treasury Regulations should prevail over conflicting local law on the standard to be used when measuring the substantiality of a general partner's assets.[88] Because the Treasury Regulations are silent on establishing a specific standard for individuals, local law should be examined to determine whether any minimum standards are effective.[89] The statement of policy adopted by the Midwest Securities Commissioners Association on real estate programs generally requires that the "financial condition of the general partner or general partners . . . be commensurate with any financial obligations assumed in the offering and in the operation of the program."[90] More specifically, the association's regulation provides:

> As a minimum, the general partners shall have an aggregate financial net worth, exclusive of home, automobile and home furnishings, of the greater of either $50,000 or an amount at least equal to 5% of the gross amount of all offerings sold within the prior 12 months plus 5% of the gross amount of the current offering, to an aggregate maximum net worth of the general partners of one million dollars. In determining net worth for this purpose, evaluation will be made of contingent liabilities to determine the appropriateness of their inclusion in the computation of net worth.[91]

This regulation provides a standard for measuring the substantiality of an individual general partner's assets.

The substantiality of assets is undeniably determined by reference to the total contributions made to the limited partnership. The question remains about what specific items should be included in the total contributions tally. Actual cash payments made by the limited partners rather than total committed capital should be in-

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[86]Treas. Reg. § 301.7701-2(d)(1) (1965) (emphasis added).

[87]*Id.* § 301.7701-2(d)(2).

[88]*See id.* § 301-7701-1(c).

[89]*Id.* § 301.7701-2(d)(1).

[90][1976] 1 BLUE SKY L. REP. (CCH) ¶ 4821, at 635.

[91]*Id.*

cluded, at least when the balance of the capital commitment is evidenced only by a subscription agreement.[92] If the balance of the commitment is evidenced by a negotiable promissory note, the amount of the capital contribution should include the fair market value of such notes.[93] In addition, if other noncash property is contributed, the contributions should include the current market value of such assets.[94]

Certain loan transactions also raise problems when determining the total contributions made to the limited partnership. It was determined in a recent revenue ruling that a nonrecourse loan[95] "from the general partner [corporate or otherwise] to a limited partner or to the partnership is a contribution to the capital of the partnership by the general partner rather than a loan."[96] Such loans naturally increase the total contributions to the limited partnership and thereby require a higher net worth for the general partner to qualify under the substantial asset test.

Nonrecourse third party loans have a vastly different impact. Originally, nonrecourse third party loans to the limited partnership, which gave the creditor the option of obtaining an equity interest in the partnership were treated as capital "placed at the risk of the venture."[97]

Currently, the IRS will not provide an advance ruling that an organization qualifies as a limited partnership for tax purposes if a "creditor who makes a nonrecourse loan to the limited partnership [has or can] acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital or property of the limited partnership other than as a secured creditor."[98] Therefore, an arm's length nonrecourse loan made by a lender, who is neither a partner nor an affiliate of a partner and who does not obtain an equity interest or a right to such an interest in the partnership, should have no effect on the total contributions to the limited partnership. Thus, the nonrecourse loan will not increase the general partner's net worth.

The treatment of nonrecourse loans is important not only for determining what total contributions have been made to the partnership but also for comparing the general partner's net worth to

[92]Tax Mngm't Portfolio (BNA), No. 161-2, at A-31 (1975).

[93]*Id.*

[94]*See id.*

[95]A nonrecourse loan is a type of security loan which bars the lender from action against the borrower if the security value falls below the amount required to repay the loan.

[96]Rev. Rul. 72-135, 1972-1 C.B. 200.

[97]Rev. Rul. 72-350, 1972-2 C.B. 395.

[98]Rev. Proc. 74-17, 1874-1 C.B. 439.

the potential liabilities of the limited partnership. Naturally, the substantial asset determination should focus on a comparison between the quantum of assets the general partner has to satisfy creditor claims, exclusive of his partnership investment, and the quantum of creditor claims that could arise to charge his assets.

The IRS unofficially has maintained that the general partner's net worth should be measured against total liabilities of the partnership, including nonrecourse loans.[99] In fact, the IRS would argue that an individual general partner whose current and future earning capacity is insufficient to cover the monthly payments on nonrecourse loans does not have substantial assets.[100] The IRS apparently treats proof that a substantial portion of the outstanding obligations are nonrecourse as further evidence that the organization has limited liability.[101] The IRS position, however, does not have any explicit support in the IRC or the Treasury Regulations.[102] Nonrecourse loans by definition do not permit recourse against the general partner personally and therefore should be ignored when determining the substantiality of the assets that the general partner has at risk, exclusive of his partnership interest, to satisfy a creditor's claims.

IV. Summary

To prove that a limited partnership possesses the corporate trait of limited liability, the IRS must show that the general partner does not possess substantial assets *and* is a dummy for the limited partners. The only federal guidelines on the substantial assets test are those dealing with the limited situation in which the sole general partner is a corporation. For all other general partner situations, the substantial assets determination is undefined. The state blue sky regulations, however, should fill this gap for federal tax purposes.

The problem of defining "dummy," however, is not as easily resolved. If a "dummy" is defined as a general partner that is controlled by the limited partners to the extent that the limited part-

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[99]*Shop Talk*, 41 J. Tax 382, 382 (1974).

[100]*Id.*

[101]*Id.*

[102]Treas. Reg. § 301.7701-2(d)(2) (1965) arguably supports the IRS position. The regulation provides in pertinent part:

> Furthermore, if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of *the obligations of the organization.*

Id. (emphasis added).

ners have personal liability under section 7 of the U.L.P.A., then the regulation is circular and meaningless. Unfortunately, a number of judicial decisions support that definition.

A more rational interpretation can be offered for the "dummy" term. Most jurisdictions agree that section 7 requires as a minimum that the limited partners take some active participation in the partnership to expose them to personal liability. *Larson* provided three possible definitions for the "dummy" term. Two of the three definitions indicate that a dummy should be a general partner that the limited partners have the power to control. The power to control a general partner and active participation under section 7 are clearly different standards for measuring the limited partners' involvement in the partnership. If the limited partner has the power to control, then the general partner is a dummy. Logically, if the limited partners only possess the power to control and do not actively participate in the partnership, the limited partners are not personally liable under section 7 of the U.L.P.A.

Limited partners possess the power to control the general partner when the partnership agreement or certificate provides that the limited partners have the power to remove the general partner, to approve or disapprove the sale of all or substantially all of the assets of the partnership, and to amend the partnership agreement or certificate. Some control, however, is permitted without causing the general partner to be a dummy. The powers to cause dissolution and to approve or disapprove the admission of a new general partner are permissible. Any powers granted in the partnership agreement or certificate beyond the two approved powers may cause the general partner to be deemed a dummy because the limited partners possess the power to control.

The 1976 Revised U.L.P.A. requires that the limited partners possess the power to control the general partner. The blue sky regulations also require that the limited partners possess the power to control, provided such powers are permitted as a matter of state law. These guidelines unfortunately fail to consider their impact on the dummy concept under the tax regulations. The best advice is to remain within the safe harbor of the sanctioned powers of the current U.L.P.A. when determining the amount of control that limited partners should possess over general partners.

Exhaustion Requirements in *Younger*-Type Actions: More Mud in Already Clouded Waters

*Mildred L. Calhoun**

The Supreme Court's 1971 decision in *Younger v. Harris*[1] heralded a new era of Court-imposed restrictions on the access of civil rights litigants to the federal courts. The *Younger* Court held that absent extraordinary circumstances a state court defendant could not obtain a federal injunction against his pending state criminal prosecution.[2] Although the opinion set forth a relatively simple rule to be applied by the lower courts, the implications of that simple rule have turned out to be complex. Since 1971, the Court has devoted a great deal of time to the *Younger* doctrine, and in so doing has created a hopeless quagmire which has confused the lower courts and outraged the commentators. One development has been the Court's application of the exhaustion doctrine, generally associated with administrative law, to some *Younger*-type actions. This Article will examine the development of the *Younger* doctrine, focusing on the exhaustion requirement and its effects upon federal civil rights litigants.[3]

I. The *Younger* Doctrine

The *Younger* doctrine was set forth in *Younger v. Harris* and five companion cases.[4] Although the *Younger* Court argued that its decision rested on precedent and recognized federal policy, the opinion in fact represented a radical departure from the Court's earlier practice.[5]

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*Trial Attorney, Antitrust Division, United States Department of Justice, Washington, D.C.; J.D., Indiana University School of Law—Indianapolis, 1978. The views expressed herein represent those of the author and not the Department of Justice.

[1]401 U.S. 37 (1971).

[2]*Id.* at 41.

[3]For a general discussion of the *Younger* doctrine, see C. Wright, Handbook of the Law of Federal Courts § 52A (3d ed. 1976).

[4]Byrne v. Karalexis, 401 U.S. 216 (1971) (per curiam); Dyson v. Stein, 401 U.S. 200 (1971) (per curiam); Perez v. Ledesma, 401 U.S. 82 (1971); Boyle v. Landry, 401 U.S. 77 (1971); Samuels v. Mackell, 401 U.S. 66 (1971).

[5]In the words of one commentator, "to the extent the Court based *Younger* on prior law, it relied upon sheer mythology, a total misconception of pre-*Dombrowski* history and precedent." Wechsler, *Federal Courts, State Criminal Law and the First Amendment*, 49 N.Y.U. L. Rev. 740, 875 (1974). For general criticism of the Court's use of precedent in *Younger*, see Soifer & Macgill, *The* Younger *Doctrine: Reconstructing*

Harris had been indicted in a California state court for allegedly violating the California Criminal Syndicalism Act.[6] Harris then filed an action in federal court asking the court to enjoin Younger, the state district attorney, from prosecuting him under the Act, alleging that the Act infringed upon his first and fourteenth amendment rights. The Supreme Court held that the federal court should abstain from enjoining the state court proceeding.[7] The Court was concerned that a federal court injunction against Harris' prosecution would interfere with state court process in a way which was repugnant to principles of comity and "Our Federalism." The Court described "Our Federalism" as

> a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States.[8]

Furthermore, the Court noted the general equitable principle that, unless the moving party will suffer irreparable injury, an equity court should not enjoin an ongoing criminal prosecution because there is an adequate remedy at law, that is, the defense of the state court prosecution.[9]

Nevertheless, the Court indicated that there might be certain "extraordinary" circumstances in which defense to the state prosecution would not be an adequate remedy and, therefore, *Younger* would not preclude federal injunctive relief. These *Younger* exceptions would include prosecution brought in bad faith or for purposes of harassment,[10] prosecution under a statute which is "flagrantly and patently violative of express constitutional prohibitions in every clause, sentence and paragraph,"[11] and "[o]ther unusual situations calling for federal intervention . . . ."[12] Because Harris did not establish that his prosecution fell under any of these exceptions, the Court indicated that equity, comity, and federalism required the federal court to deny injunctive relief.[13]

Reconstruction, 55 TEX. L. REV. 1141, 1144-67 (1977); Weinberg, *The New Judicial Federalism*, 29 STAN. L. REV. 1191, 1206-09 (1977).

[6] CAL. PENAL CODE §§ 11400-11401 (West 1970).

[7] 401 U.S. at 41.

[8] *Id.* at 44.

[9] *Id.* at 43-44.

[10] *Id.* at 47-49 (construing Dombrowski v. Pfister, 380 U.S. 479 (1965)).

[11] 401 U.S. at 53 (quoting Watson v. Buck, 313 U.S. 387, 402 (1941)).

[12] 401 U.S. at 54.

[13] *Id.* at 43-54.

In *Samuels v. Mackell*,[14] a companion case to *Younger*, the Court denied a state court defendant's request for a federal judgment declaring unconstitutional the state law under which he was being prosecuted.[15] The Court's decision that the availability of federal declaratory relief must be tested by *Younger* principles was based on its conclusion that although injunctive and declaratory relief are distinct legal remedies, "the practical effect of the two forms of relief will be virtually identical, and the basic policy against federal interference with pending state criminal prosecutions will be frustrated as much by a declaratory judgment as it would be by an injunction."[16]

Thus, *Younger* and *Samuels* taken together preclude a state court defendant from obtaining equitable relief in federal court unless a *Younger* exception applies. If the federal plaintiff is subject to a pending state court prosecution and no extraordinary circumstances are present, then neither declaratory nor injunctive relief may be granted.

In *Samuels*, the Court had expressly left open the question of the propriety of federal declaratory relief in the absence of a pending state proceeding.[17] This question reached the Court in *Steffel v. Thompson*.[18] Becker and Steffel had been threatened with arrest while distributing handbills at a local shopping center. Steffel ceased handbilling at the threat of arrest,[19] but Becker continued to distribute handbills and was arrested. Steffel and Becker brought an action in federal court challenging the validity of the statute under which Becker had been arrested. The lower federal courts held that *Younger* precluded both Steffel and Becker from obtaining injunctive or declaratory relief in federal court.[20] Steffel appealed to the Supreme Court from the denial of declaratory relief. The Court held that Steffel could obtain a declaratory judgment in federal court because he was not being prosecuted in state court and because he had shown "a genuine threat of enforcement of a disputed state criminal statute . . . ."[21] The Court reasoned that when the federal

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[14]401 U.S. 66 (1971).

[15]*Id.* at 73.

[16]*Id.*

[17]*Id.* at 73-74.

[18]415 U.S. 452 (1974).

[19]The parties stipulated that Steffel might have been arrested had he continued handbilling. *Id.* at 456.

[20]*See* Becker v. Thompson, 334 F. Supp. 1386 (N.D. Ga. 1971), *aff'd*, 459 F.2d 919 (5th Cir. 1972).

[21]415 U.S. at 475. In Doran v. Salem Inn, Inc., 422 U.S. 922 (1975), a *Steffel*-type case decided one year after *Steffel*, the Court held under the facts that the federal plaintiffs were entitled to a preliminary injunction without meeting the *Younger* test pending disposition of their request for declaratory relief. *Id.* at 930-31.

plaintiff is not the subject of a pending state proceeding, principles of equity, comity, and federalism do not preclude federal intervention in the form of a declaratory judgment, which Congress intended "as an alternative to the strong medicine of the injunction . . . ."[22]

The *Steffel* decision is the cornerstone of the *Younger* paradox, for it provides the basis upon which the courts must decide which litigants can proceed in federal court despite possible effects on the state court. Although *Steffel* appears sensible on its face, a close analysis reveals that the case rests on a formalistic distinction. The *Younger* doctrine is designed to protect state courts from undue federal interference. The *Steffel* Court, however, defined undue federal interference with a state court solely in terms of the identity of the federal plaintiff; instead of looking to potential impact or interference in the state court, the Court asked only whether the federal plaintiff was the subject of a pending state proceeding. This identity-based distinction, although apparently easy to apply,[23] is not necessarily meaningful.

To best illustrate the "*Younger* paradox," it is useful to look at a hypothetical case. *A* distributes handbills at a local shopping center and is arrested for violating a state statute which is suspect. Because *A* cannot establish that her prosecution falls under any *Younger* exception, *Younger* and *Samuels* preclude her from challenging the statute in federal court. Nevertheless, *A*'s friend *B*, who also distributed handbills but left before the arrests took place, can now obtain federal declaratory relief which will effectively prevent enforcement of the statute.[24] Assuming that the federal court grants relief before *A*'s trial in state court, there can be little doubt that as a practical matter, *A*'s prosecution will be terminated as surely as if *A* had obtained the relief independent of *B*'s action.

Clearly, there is a formal distinction between the relief obtained by *A* and that obtained by *B*. If *A* has already been prosecuted and convicted when *B* obtains federal relief, *A* will probably be unable to

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[22]415 U.S. at 466.

[23]Essentially, *Steffel* states that if the federal plaintiff is currently being prosecuted in state court, relief would impermissibly interfere with the state court. In later cases such as Hicks v. Miranda, 422 U.S. 332 (1975), the Court obscures the definition of who is currently being prosecuted. *Hicks* is discussed in notes 31-39 *infra* and accompanying text.

[24]To the extent that *Steffel* does not mandate this result, later cases clearly command it. Because Becker did not appeal the lower court's decision, the Supreme Court in *Steffel* did not consider the outcome of a case in which there are two closely related federal plaintiffs, one who is subject to state prosecution and one who is not. This fact situation was presented in Doran v. Salem Inn, Inc., 422 U.S. 922 (1975), in which the Court determined that *Younger* would permit the party not being prosecuted to bring a federal action. *Id.* at 930.

collaterally attack her conviction.[25] If *A* has not yet been prosecuted it is conceivable, but unlikely, that the prosecution against her will proceed after a federal court has declared the statute unconstitutional. Under certain circumstances, *B*'s federal judgment may actually be binding upon *A*'s prosecutor or the court in which she is tried.[26] Even without considering the res judicata effect of a federal declaratory judgment, however, it is clear that as a practical matter a prosecutor would be reluctant to proceed under these circumstances. In fact, proceeding after the statute had been declared unconstitutional might be considered bad faith prosecution, permitting *A* to seek federal relief under the bad faith prosecution exception outlined in *Younger*.[27]

Thus, there is a technical distinction between a judgment obtained by *A* and a judgment obtained by *B*. Simply stated, a judgment granted to *A* will definitely halt her prosecution, but a judgment granted to *B* will only probably halt *A*'s prosecution. Is this the stuff of which comity is made? Is not the interference with the state system just as profound in the second instance as it is in the first? Arguably it may be less offensive to inform a state court that the statute under which it is prosecuting *A* is unconstitutional than to direct the state court not to prosecute *A*, but the practical impact—the interference with the state court process—is virtually the same.[28]

Although it may provide cold comfort to civil rights advocates, *Steffel*, as decided, leaves the door partially ajar for civil rights litigants. If the outcome of *Steffel* had been different, the Court indeed would have "place[d] the hapless plaintiff between the Scylla of

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[25]*See* Wooley v. Maynard, 430 U.S. 705 (1977), *discussed in* notes 85-91 *infra* and accompanying text.

[26]The binding effect of *B*'s federal judgment would depend on who were parties to the federal action and the wording of any federal court order. If *A*'s prosecutor were a party to the federal action and the order prohibited prosecution under the statute, *A*'s prosecutor would probably be bound by the federal judgment. The res judicata effect of a federal declaratory judgment, however, remains unresolved. *See* Steffel v. Thompson, 415 U.S. at 469-71 (quoting Perez v. Ledesma, 401 U.S. 82, 124-26 (1971) (Brennan, J., concurring in part and dissenting in part)).

[27]Justice Rehnquist, however, argues to the contrary in his concurring opinion in *Steffel*:

> [A]ttempts to circumvent *Younger* by claiming that enforcement of a statute declared unconstitutional by a federal court is *per se* evidence of bad faith should not find support in the Court's decision in this case. . . . [C]ontinued belief in the constitutionality of the statute by state prosecutorial officials would not commonly be indicative of bad faith . . . .

415 U.S. at 483 (Rehnquist, J., concurring).

[28]It is interesting to note that in Samuels v. Mackell, 401 U.S. 66 (1971), *discussed in* notes 14-17 *supra* and accompanying text, the Court looked to the practical impact as opposed to the legal distinctions.

intentionally flouting state law and the Charybdis of foregoing what he believes to be constitutionally protected activity in order to avoid becoming enmeshed in a criminal proceeding."[29] A decision prohibiting potential state court defendants from litigating in federal court would have been a logical extension of *Younger*, but would have radically restricted access to the federal courts by civil rights litigants—so radically, in fact, that it might have caused the Justices to reconsider the wisdom of *Younger*. Such a decision would have all but shut the door on challenges to state statutes in federal court. A federal plaintiff who was the subject of a pending state court prosecution would have been precluded by *Younger* and *Samuels* from obtaining relief in federal court, and a federal plaintiff who, although not the subject of a pending prosecution, could show a real threat of state court prosecution, would not have had standing to maintain a federal action.[30] Of course, the Court did not decide *Steffel* in the manner suggested, but instead held that *Younger* does not preclude federal declaratory relief when a prosecution is merely threatened rather than in progress.

The Court continued to refine, and in so doing, to complicate, the *Younger* doctrine in *Hicks v. Miranda*.[31] In *Hicks*, the Court held that a federal plaintiff who was not himself the subject of state proceedings would be bound by *Younger* principles if his interests "intertwined" with those of someone who was being prosecuted[32] or if the state prosecutor filed an action against the federal plaintiff after the federal action had been filed "but before any proceedings of substance on the merits [had] taken place in the federal court . . . ."[33] In *Hicks*, the prosecutor filed criminal misdemeanor charges against employees of a theatre for violating a state nuisance statute; as a result, the theatre was closed. The owners of the theatre filed an action in federal court challenging the statute under which the employees had been prosecuted.

The Supreme Court held that abstention under *Younger* was required under either of two theories. First, the Court found that the theatre owners "had a substantial stake in the state proceedings, so much so that they sought federal relief, demanding that the state statute be declared void and their films be returned to them. Obvious-

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[29]415 U.S at 462.

[30]This "Catch 22" approach was actually the outcome of Juidice v. Vail, 430 U.S. 327 (1977). In that case, the Court held, under a limited fact situation, that those plaintiffs who were not being prosecuted in state court and were therefore not subject to *Younger* had no standing, but those persons who were being prosecuted in state court, and therefore had standing, were subject to *Younger*. *Id.* at 331-33.

[31]422 U.S. 332 (1975).

[32]*Id.* at 348-49.

[33]*Id.* at 349.

ly, their interests and those of their employees were intertwined . . . ."[34] Thus, the federal plaintiffs would be regarded for purposes of the federal action as defendants to the state prosecution. The Court did little else to define "intertwining," leaving the lower courts to fend for themselves.[35]

The Court gave a second ground to support the result in *Hicks*. After the federal action had been filed, the state prosecutor amended the criminal action to name the theatre owners as defendants. The Supreme Court held that this state prosecution, commenced after the federal action, constituted a "pending proceeding" for *Younger* purposes:

> Neither *Steffel v. Thompson* . . . nor any other case in this Court has held that for *Younger v. Harris* to apply, the state criminal proceedings must be pending on the day the federal case is filed. . . . [W]e now hold that where state criminal proceedings are begun against the federal plaintiffs after the federal complaint is filed but before *any proceedings of substance on the merits have taken place in the federal court*, the principles of *Younger v. Harris* should apply in full force.[36]

The holding in *Hicks* is disturbing for both practical and pedagogical reasons. On the practical level, the Court created still another technical complexity for federal courts trying to determine the applicability of *Younger* principles. The *Younger* test no longer involved the simple question whether the federal plaintiff was subject to a pending state court criminal prosecution. Now the test was more complicated: (1) Was the federal plaintiff subject to a pending state court criminal prosecution at the time the federal complaint was filed? (2) Was a state court proceeding filed against the federal plaintiff before proceedings of substance on the merits had transpired in the federal action? (3) Is the federal plaintiff, not himself the subject of state proceedings when the federal action was filed, nonetheless "intertwined" with a party who was then subject to an ongoing state court prosecution? A "yes" answer to any of these questions would invoke *Younger* abstention.

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[34]*Id.* at 348-49.

[35]*Hicks* is the only case in which the Supreme Court has mentioned the "intertwining" standard. In Doran v. Salem Inn, Inc., 422 U.S. 922 (1975), the Court characterized as "Procrustean" the position taken by the lower court that three corporate entities challenging the same statute, represented by the same counsel, and possessing apparently identical interests should be subject to the same *Younger* considerations. *Id.* at 928-29.

[36]422 U.S. at 349 (emphasis added).

Pedagogically, *Hicks* represents a radical abdication of jurisdiction by federal courts. If *Younger* stands for the proposition that a federal court cannot interfere with ongoing state proceedings, then *Hicks* stands for the proposition that state prosecutors can interfere with ongoing federal proceedings.[37] After *Hicks*, a state prosecutor can terminate a federal action filed against him by instituting proceedings against the federal plaintiff under the challenged ordinance before "proceedings of substance on the merits" have transpired in the federal action.[38] Surely this result would seem to "turn federalism on its head."[39]

II. Abstention and Exhaustion

In this climate of confusing and sometimes contradictory abstention mandates, the Court decided *Huffman v. Pursue, Ltd.*[40] The application of abstention in the *Huffman* context was so novel that the Supreme Court found no indication that the district court had even considered *Younger* principles.[41] *Huffman* is significant for two reasons. First, it was the earliest case in which the Court, which had previously applied *Younger* only in the criminal context, held the *Younger* doctrine applicable to those civil cases which, because they involve important state interests, are "akin" to state prosecutions.[42] Second, it was the first case in which the Court applied the *Younger* doctrine when no proceeding was in progress at the state court level. According to the Court, abstention was appropriate because the federal plaintiff had failed to exhaust his state court remedies.[43]

In *Huffman*, the federal plaintiff, Pursue, Ltd., attempted to challenge the validity of an Ohio statute which provided that a place

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[37]*See id.* at 353-57 (Stewart, J., dissenting).

[38]422 U.S. at 349. The assumption—which is in no way unreasonable—is that the prosecutor can validly prosecute the federal plaintiff: to have established standing to bring the federal action, the federal plaintiff must have shown he was subject to a real and immediate threat of prosecution. Steffel v. Thompson, 415 U.S. at 459.

Of course, if a state prosecutor were to prosecute without sufficient grounds merely to remove the case from federal court, this might well constitute bad faith. If so, abstention would not be required under *Younger*.

[39]Steffel v. Thompson, 415 U.S. at 472.

[40]420 U.S. 592 (1975).

[41]*Id.* at 599.

[42]*Id.* at 604. Soon to follow were Trainor v. Hernandez, 431 U.S. 434 (1977), and Juidice v. Vail, 430 U.S. 327 (1977), in which the Court went even further than it had gone in *Huffman*, extending *Younger* to civil cases in which the state has a significant interest. *See also* Moore v. Sims, 99 S. Ct. 2371 (1979).

The application of *Younger* to civil cases may have been a logical extension of the doctrine, but it was not a happy one. No other single *Younger* development has provoked such critical fire. *See, e.g.*, Shaman & Turkington, Huffman v. Pursue, Ltd.: *The Federal Courthouse Door Closes Further*, 56 B.U.L. Rev. 907 (1976).

[43]420 U.S. at 608.

which exhibits obscene films is a nuisance. Prior to the federal action, the state prosecutor had instituted a civil nuisance proceeding in the Ohio courts against the plaintiff's predecessor in interest. After Pursue, Ltd. had succeeded to the leasehold interest of the state court defendant, the Ohio court issued a final judgment ordering closure of the theatre for a year and seizure and sale of personal property used in the operation of the theatre.

In the federal action, Pursue, Ltd. argued, *inter alia*, that *Younger* was inapplicable because no state court action was pending. In *Steffel*, the Court had held that *Younger* would not preclude federal declaratory relief when there was a genuine threat of future prosecution, but no pending prosecution. Because the Ohio court had entered a final judgment and, arguably, the proceeding was terminated, the federal plaintiff claimed that there was no pending prosecution.

The Supreme Court did not consider the question whether the Ohio court's judgment was final, but instead held *Younger* applicable because the federal plaintiff had failed to take appeal from his state court judgment to the state appellate system:

> [R]egardless of when the Court of Common Pleas' judgment became final, we believe that a necessary concomitant of *Younger* is that a party in appellee's posture must exhaust his state appellate remedies before seeking relief in the District Court, unless he can bring himself within one of the exceptions specified in *Younger*.[44]

According to the Court, federal intervention in the state process before exhaustion of state appellate remedies would be duplicative and disruptive. Furthermore, the Court recognized that "[f]ederal post-trial intervention, *in a fashion designed to annul the results of a state trial*, also deprives the States of a function which quite legitimately is left to them, that of overseeing trial court dispositions of constitutional issues which arise in civil litigation over which they have jurisdiction."[45]

Thus, *Huffman* further complicates the tests set forth in earlier cases. Now, federal courts had to resolve the following questions: (1) Was the federal plaintiff subject to a pending state court criminal prosecution *or a state civil action involving important state interests* when the federal complaint was filed? (2) Was a state proceeding filed against the federal plaintiff before proceedings of substance on the merits had transpired in the federal action? (3) Is the federal plaintiff, not himself the subject of state proceedings

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[44] *Id.*

[45] *Id.* at 609 (emphasis added).

when the federal action was filed, nevertheless "intertwined" with a party who was then subject to an ongoing state court proceeding? (4) *Is the federal relief designed to annul the results of a state proceeding?*

The imposition of an exhaustion requirement in a section 1983[46] action inspired grave doubts about the continued validity of *Monroe v. Pape.*[47] In *Monroe*, the Court held that a federal plaintiff need not exhaust state court remedies before bringing a section 1983 action in federal court: "It is no answer that the State has a law which if enforced would give relief. The federal remedy is supplementary to the state remedy, and the latter need not be first sought and refused before the federal one is invoked."[48]

Justice Brennan in his dissenting opinion in *Huffman* stated that "[t]he extension . . . of *Younger v. Harris* to require exhaustion in an action under [section] 1983 drastically undercuts *Monroe v. Pape* and its numerous progeny . . . ."[49] Nevertheless, Justice Rehnquist for the majority asserted that the exhaustion requirement did not undermine *Monroe v. Pape.*[50] Rehnquist maintained that in *Monroe*, the Court held "that one seeking redress under . . . [section] 1983 for a deprivation of federal rights need not first initiate state proceedings based on related state causes of action."[51] He distinguished *Monroe* on the ground that it "had nothing to do with the problem [before the Court in *Huffman*] of the deference to be accorded state proceedings which have already been initiated and which afford a competent tribunal for the resolution of federal issues."[52]

Thus, the majority in *Huffman* indicated that as long as the federal plaintiff had not initiated any action in state court, and no state action had been initiated against him, the federal forum would remain open and exhaustion of state remedies would not be required. As Justice Brennan indicated in his dissenting opinion, however, there was some fear that the *Huffman* exhaustion require-

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> [46]Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1970).

[47]365 U.S. 167 (1961), *overruled on other grounds*, Monell v. Department of Social Servs., 436 U.S. 658 (1978).

[48]365 U.S. at 183.

[49]420 U.S. at 617 (Brennan, J., dissenting).

[50]420 U.S. at 609 n.21.

[51]*Id.*

[52]*Id.* at 609-10 n.21.

ment would be extended to create a serious stumbling block to obtaining federal relief under section 1983.[53]

Despite the fears voiced by the *Huffman* dissenters and commentators, the Court has recently indicated that the exhaustion requirement will not be interpreted broadly. In *Redhail v. Zablocki*,[54] the federal plaintiffs challenged, under section 1983, a Wisconsin statute which required certain residents to obtain a court order before they could marry. The district court considered whether *Younger* and *Huffman* would require the federal plaintiff to challenge the Wisconsin statute in state court and determined that *Younger* need not be invoked because there was no pending proceeding in the state court.[55] Furthermore, the court discussed the *Huffman* exhaustion requirement and concluded, citing *Monroe v. Pape*, that a federal plaintiff proceeding under section 1983 need not first apply to the state courts for relief.[56]

The Supreme Court affirmed the lower court's decision, but summarily disposed of the abstention issue in a footnote: "[T]he District Court was correct in finding *Huffman* and *Younger* inapplicable, since there was no pending state-court proceeding in which appellee could have challenged the statute."[57] The mere fact that there was no pending prosecution should not have been a sufficient reason to dismiss the abstention issue.[58] In *Huffman*, the Court had held that the exhaustion requirement did not depend upon whether there was a *pending* action. In fact, there was no pending action in *Huffman*, but abstention was required because the federal plaintiff had failed to make a timely appeal of the judgment against it. Actually, the appropriate test to be applied in *Redhail*, which the Court set forth in *Huffman*, would have been whether the federal relief was designed to annul the results of a state trial. Despite the fact that the *Redhail* Court applied the wrong test, the Court was obviously correct in its conclusion that *Huffman* did not require abstention because in *Redhail* there had been no state trial. *Redhail* thus indicates, at least by inference, that the Court does not intend to require abstention for failure to exhaust state remedies unless

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[53]*See, e.g.*, Bartels, *Avoiding a Comity of Errors: A Model for Adjudicating Federal Civil Rights Suits that "Interfere" with State Civil Proceedings*, 29 STAN. L. REV. 27, 30 n.8 (1976); Soifer & Macgill, *supra* note 5, at 1182.

[54]418 F. Supp. 1061 (E.D. Wis. 1976), *aff'd*, 434 U.S. 374 (1978).

[55]418 F. Supp. at 1065.

[56]*Id.* (citing Monroe v. Pape, 365 U.S. 167 (1961)).

[57]434 U.S. at 380 n.5.

[58]The Court may have meant that there was no proceeding, pending or otherwise, in the state court and that it was therefore unnecessary to apply the *Huffman* test, that is, to ask whether the federal relief would annul the results of a state trial. Nevertheless, the Court specifically referred to a *pending* proceeding.

there has been a state proceeding which would be interfered with in some way if relief were to be granted.

A. Huffman *and the Civil Rights Litigant*

The assurance that *Huffman* will not be extended to overrule *Monroe v. Pape* provides little comfort to the prospective federal plaintiff who, like the plaintiff in *Huffman*, does not choose the state forum but has it chosen for him by the state prosecutor. As in *Hicks*, the Supreme Court in *Huffman* gave the state prosecutor the opportunity to choose the preferred forum, and a state prosecutor will inevitably choose the state court. Absent extraordinary circumstances, once the prosecutor has initiated an action in state court, the state court defendant must pursue his state appellate remedies before commencing a federal action. As recognized by the dissenters in *Huffman*, "the mere filing of a complaint against a potential [section] 1983 litigant forces him to exhaust state remedies."[59]

The prospective federal plaintiff's plight is further aggravated by the *Hicks* definition of a pending prosecution which would invoke *Younger* principles as one filed before "proceedings of substance on the merits" have begun in the federal action.[60] Although the prospective federal plaintiff may win the race to the federal courthouse, he would still lose if the state prosecutor files in state court before proceedings of substance have taken place in the federal court.

The Court apparently saw no inequity in relegating the plaintiff in *Huffman* to the state courts—at least no inequity which outweighed the competing interests of federalism. In fact, the *Huffman* Court concluded that the federal plaintiff should not be permitted the "luxury" of litigating in federal court when that "luxury" is so "costly" to federalism.[61] The Court's willingness to relegate the federal plaintiff to the state courts rests on two basic assumptions. The first assumption, often repeated in *Younger* cases, is that state courts have a constitutionally imposed responsibility to enforce the Constitution and that the Court will not assume that the state courts are either unable or unwilling to enforce constitutional mandates.[62] The second assumption is that the aggrieved defendant has the option of appealing an adverse state decision to the United States Supreme Court and may in fact be able to appeal as a matter of right.[63] These safeguards, argues the Court, provide an adequate federal remedy.

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[59]420 U.S. at 617 (Brennan, J., dissenting).
[60]422 U.S. at 349.
[61]420 U.S. at 605-06.
[62]*Id.* at 611. *See also* Moore v. Sims, 99 S. Ct. 2371 (1979).
[63]420 U.S. at 605.

Neither of these assertions is particularly convincing. The Court's assumption that state courts are at least as capable of determining constitutional issues as federal courts is directly contrary to the express purpose and mandate of Congress in enacting section 1983. It is only logical to assume that federal courts will be more familiar with federal issues than state courts. Federal decisions made by the federal judiciary will also tend to be more uniform than those made by state court judges, because the federal judiciary is a more cohesive group than the state judiciary.[64]

Furthermore, federal constitutional decisions may be controversial and unpopular. Federal judges appointed for life are not subject to reelection or reappointment. The singular ability of the federal judiciary to protect the constitutional rights of citizens is best illuminated by asking one question: Where would the civil rights movement be today if it had depended upon the state courts to enforce constitutional guarantees of equal protection?

Fortunately, this question need never be answered because Congress has provided a remedy which enables civil rights advocates to challenge deprivations of civil rights under color of state law in federal court. This remedy is section 1983, which allows persons aggrieved by state authorities to bypass the state courts and sue in federal court. To the extent that *Younger* and cases like *Huffman* have limited the availability of the federal forum, the Court has undermined the congressional grant of jurisdiction. As the Supreme Court itself recognized in *Mitchum v. Foster*,[65] "[t]he very purpose of [section] 1983 was to interpose the federal courts between the States and the people, as guardians of the people's federal rights—to protect the people from unconstitutional action under color of state law, 'whether that action be executive, legislative, or judicial.' "[66]

The Court's assumption that appeal to the Supreme Court provides an adequate remedy is also subject to criticism. Fewer than ten percent of all petitions for review are granted.[67] And although a final decision of a state court which sustains the validity of a state statute on federal constitutional grounds is appealable to the Supreme Court as a matter of right,[68] the Court summarily disposes of most such cases.[69] A ten percent chance of consideration by the

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[64]*See* Soifer & Macgill, *supra* note 5, at 1185; Wells, *Preliminary Injunctions and Abstention: Some Problems in Federalism*, 63 CORNELL L. REV. 65, 74-75 (1977).

[65]407 U.S. 225 (1972).

[66]*Id.* at 242 (quoting *Ex parte* Virginia, 100 U.S. 339, 346 (1879)).

[67]Casper & Posner, *A Study of the Supreme Court's Caseload*, 3 J. LEGAL STUD. 339, 361, 367 (1974).

[68]28 U.S.C. § 1257(2) (1970).

[69]Erwin N. Griswold, former Solicitor General of the United States (1968-1973) has stated that "[w]ith few exceptions, appeals are treated as discretionary, and are

Supreme Court cannot be as effective an alternative as full review of the merits by a lower federal factfinder.

The *Younger* line of cases has rejected the idea that a litigant might have a legitimate interest in litigating in federal, as opposed to state, court. This closing of the federal courthouse doors may be the result, not of principle and precedent, but of a desire to limit the ever increasing caseload of the federal courts.

B. Applications of Huffman *in the Lower Courts*

The *Huffman* exhaustion rule has continued to generate confusion in the lower courts. In *Kahn v. Shainswit*,[70] the plaintiff, Kahn, requested a federal court order restraining a New York state judge from enforcing a state statute which foreclosed Kahn from counterclaiming in a state court divorce action in which he was a defendant. The district court recognized that *Huffman* had expanded *Younger* to the civil context and found that it was applicable to the case. The court observed that because Kahn was not foreclosed from appeal in the state courts and had failed to exhaust his state court remedies, abstention was required.[71]

Actually, the court in *Kahn* did not have to consider the exhaustion issue. Because the state court judge had not issued a final order[72] there was still a pending state court action to which the federal plaintiff was subject. Technically, the exhaustion issue should only be raised after a determination that there is no pending prosecution.[73]

One disturbing application of the *Younger* exhaustion doctrine has been the use of *Huffman* by some federal courts as a basis for denying pretrial habeas corpus relief. In *Ex parte Royall*,[74] the Supreme Court held that a federal court could use its discretion in determining whether to grant habeas relief to a state court defend-

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routinely dismissed 'for want of a substantial federal question.' " Griswold, *Rationing Justice—The Supreme Court's Caseload and What the Court Does Not Do*, 60 CORNELL L. REV. 335, 345 (1975).

[70]414 F. Supp. 1064 (S.D.N.Y. 1976).

[71]*Id.* at 1068.

[72]*Id.* at 1065.

[73]This may be overstating the case. In *Huffman*, the Court did not determine whether the state court's order became final before or after the federal filing. The Court considered such an inquiry unnecessary because it found that exhaustion was required in any event. 420 U.S. at 608. In *Kahn*, however, it was clear that no final order had been entered in the state action when the federal action was decided. *See* 414 F. Supp. at 1065. Therefore, it was unnecessary to reach the exhaustion issue.

[74]117 U.S. 241 (1886).

ant who had not been tried, but who had exhausted all state *pretrial* remedies. Nevertheless, in *Schlesinger v. Councilman*,[75] the Court noted in dicta that the "considerations of comity" inherent in *Younger* "underlie the requirement that petitioners seeking habeas relief . . . must first exhaust available state remedies . . . ."[76] In *United States v. New York*,[77] the Second Circuit denied a pretrial petition for habeas corpus, even though the state court defendant had exhausted all of her pretrial remedies, on the ground that *Younger* and *Huffman* required the state court defendant to exhaust all state court options. According to the court, the defendant had two choices: she could raise her constitutional defenses at trial in the state court, or she could plead guilty and raise them on appeal in the state appellate system. In *Drury v. Cox*,[78] the Ninth Circuit reached a similar conclusion:

> Our reading of *Younger v. Harris* . . . convinces us that only in the most unusual circumstances is a defendant entitled to have federal interposition by way of injunction or habeas corpus until after the jury comes in, judgment has been appealed from and the case concluded in the state courts. Apparent finality of one issue is not enough.[79]

Although other courts have agreed with the Second and Ninth Circuits,[80] at least one court has disagreed. In *Rivers v. Lucas*,[81] the Sixth Circuit rejected the *Drury* holding: "[W]e have found no Supreme Court decision which holds that pretrial habeas corpus relief is the equivalent of an injunction to stay proceedings in a state court."[82]

The application of *Huffman* in the habeas corpus context is particularly disturbing. The *Huffman* Court held that when federal relief is designed to annul the results of a state trial, exhaustion of state remedies is required. Thus, *Huffman*'s application to federal habeas corpus proceedings could mandate abstention in all habeas actions involving state incarcerations because the remedy of habeas corpus by its very nature is almost always designed to annul the results of a state trial.

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[75] 420 U.S. 738 (1975).

[76] *Id.* at 756.

[77] 532 F.2d 292 (2d Cir. 1976).

[78] 457 F.2d 764 (9th Cir. 1972).

[79] *Id.* at 764-65.

[80] *See, e.g.*, Dolack v. Allenbrand, 548 F.2d 891 (10th Cir. 1977); Powell v. Keve, 409 F. Supp. 228 (D. Del. 1976).

[81] 477 F.2d 199 (6th Cir.), *vacated and remanded*, 414 U.S. 896 (1973).

[82] 477 F.2d at 203.

III. *Wooley v. Maynard* and the Exhaustion Requirement

It is unfortunate that the first mention of the exhaustion requirement, in *Huffman*, was largely overshadowed by *Huffman*'s extension of *Younger* to certain civil cases.[83] The application of exhaustion in the civil context obscured the direction in which the Court was pointing. In *Huffman*, the Court was concerned with the same sort of problem which had been raised by the peculiar facts of *Hicks v. Miranda*. In both *Hicks* and *Huffman*, the state courts had ordered closure of the federal plaintiffs' theatres. In *Huffman*, the court had ordered the seizure and sale of the plaintiff's property as well. Neither case was concerned as much with stopping an ongoing prosecution as with recovering property seized by the state court. In each case, the federal plaintiff attempted to undo the state court's actions without directly challenging its decision by attacking, in federal court, the statute under which the state court had proceeded. The practical result of having prevailed in such a challenge would not have been much different than having successfully defended or appealed in the state court. Thus, in both *Hicks* and *Huffman* the federal plaintiff had an interest which could be protected only by attacking a state court proceeding in a way which the Court had determined was antithetical to *Younger* principles. The Court was stating in *Hicks* that the federal plaintiffs, although technically not subject to a pending state court action, were seeking relief which would disrupt the state court in the same manner as if the federal plaintiffs were before the state court in a pending action. The relevant factor was the impact which the relief sought would have upon the state court rather than any particular individual's status as a party to a pending proceeding. This aspect of the case, however, was obscured by the Court's continued focus on the identity of the federal plaintiff. Thus, in cases in which the relief sought amounts to a collateral attack on a state court decision, or in the Court's words, when the relief sought is "designed to annul the results of a state trial," *Huffman* requires exhaustion.[84]

In this context the exhaustion requirement does not pose a serious threat to *Monroe v. Pape* or to actions brought under section 1983 generally. *Huffman* was not really intended to overrule *Monroe* or to seriously limit its viability. *Huffman* merely creates a limited exception to the "no exhaustion" rule of *Monroe*. In situations in which the section 1983 action amounts to a collateral attack on a state court judgment, the federal plaintiff will be forced back into the state system to appeal the state court's decision. Although

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[83]*See* note 42 *supra* and accompanying text.

[84]420 U.S. at 609.

this result will not find favor with those who believe that civil rights are more important than states' rights, it in no way approaches the spectre of an exhaustion requirement in all section 1983 cases.

Applying *Huffman* in the criminal context makes the exhaustion requirement easier to understand. If Pursue, Ltd. had been prosecuted, convicted, and fined in state court for violating a criminal nuisance statute and had then come into federal court challenging the nuisance statute and demanding the return of its fine, the Court would have required the federal plaintiff to go back to the state courts to appeal its state court judgment. This is the way most of the lower federal courts have applied the exhaustion requirement.[85] What would happen if Pursue, Ltd. were prosecuted, convicted, and fined in state court and then went to federal court to challenge prospectively the application of the statute? In other words, what would be the result if the federal plaintiff did not request relief which would have a direct impact on the state court judgment?

These were the facts in *Wooley v. Maynard*.[86] George Maynard had been prosecuted repeatedly in the New Hampshire courts for obscuring the state motto "Live Free or Die" on his license plates. He had been fined and had served a fifteen-day sentence for violating an ordinance requiring display of the motto. When no proceeding was pending against Maynard,[87] he and his wife brought an action in federal court challenging the ordinance on first amendment grounds. The state argued that *Younger* and *Huffman* precluded federal intervention because Maynard had not sought review of his state court convictions and thus had failed to exhaust his state court remedies.

The Court held that exhaustion was not required because Maynard, rather than attempting to attack his state court convictions, was seeking purely prospective relief: "[Maynard] does not seek to have his record expunged, or to annul any collateral effects those convictions may have, *e.g.*, upon his driving privileges. The Maynards seek only to be free from prosecutions for future violations of the same statutes. *Younger* does not bar federal jurisdiction."[88] Thus, *Wooley* limits the exhaustion requirement to those

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[85]*See, e.g.*, Foster v. Zeeko, 540 F.2d 1310 (7th Cir. 1976); Dones-Arroyo v. Trias-Monge, 430 F. Supp. 315 (D.P.R. 1976).

[86]430 U.S. 705 (1977).

[87]Actually, Maynard's third prosecution for violation of the statute had been continued for sentencing. *Id.* at 708. Nevertheless, the district court found that "continued for sentencing" amounted to a final order in this setting, because no collateral consequences would result unless Maynard were prosecuted in the future. *Id.* at 711 n.8 (quoting Maynard v. Wooley, 406 F. Supp. 1381, 1384 (D.N.H. 1976)).

[88]430 U.S. at 711.

cases in which the federal action is, in effect, a collateral attack upon a state court proceeding. *Huffman* clearly involved such a collateral attack, for the relief requested would have dissolved the state court's order.

Is this a workable standard? And if it is, is it a reasonable one? To a certain extent, any federal judgment regarding a state statute will have some impact on the courts of that state. That, we recognize, is one of the costs of the federal system. *Younger* indicates that some types of impact are prohibited. For example, a state court defendant cannot seek a federal injunction against his ongoing state prosecution. *Steffel* indicates that some types of impact are not prohibited. Thus, a friend of a state court defendant, who is subject to a threat of prosecution but who is not being prosecuted, can go into federal court and have the statute under which the state defendant is being prosecuted declared unconstitutional. As discussed earlier,[89] this declaratory action is not barred by principles of federalism, even though it will terminate the state court prosecution as surely as if the relief had been granted to the state court defendant.

The distinctions drawn by the Court do not clearly indicate what kind of impact the requested relief must have on the state court before it will amount to relief "designed to annul the results of a state trial . . . ."[90] In *Wooley*, the Court noted that the plaintiff had not sought to have his previous record expunged and that the requested relief was purely prospective, but was it purely prospective? After the Supreme Court had issued an injunction against Maynard's future prosecution under the statute, could the state have initiated proceedings to revoke Maynard's license based on his convictions under the statute? Legally, there may be some doubt whether a state could successfully bring such an action. As a practical matter, however, it is doubtful that a state would do so. Thus, Maynard's purely prospective relief effectively expunged his record.

In short, the distinction between actions designed to annul the results of a state trial and actions requesting purely prospective relief may be one of form rather than substance. If, for example, the plaintiff in *Huffman* had not attempted to attack the state court determination, but instead had challenged the constitutionality of the statute prospectively, would that plaintiff have been barred from proceeding by *Younger*? *Wooley* suggests that he would not.[91] Does *Wooley* create an exception to *Younger* that destroys the rule?

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[89]*See* text accompanying notes 24-28 *supra*.

[90]Huffman v. Pursue, Ltd., 420 U.S. at 609.

[91]The result would depend upon whether there was a final order in the state court. If not, *Younger* would apply.

When the Court prospectively strikes down a state statute, what impact will that have on past state actions? Which types of impact on state court proceedings will be inimical to federalism and which will not? Questions such as these raise doubts not only about the soundness of the *Huffman* decision, but also about the soundness of *Younger* itself.

IV. Conclusion

The exhaustion requirement for *Younger*-type cases set forth in *Huffman* exemplifies the increasing complexity of the *Younger* doctrine. In its narrowest application, the *Huffman* exhaustion requirement prevents state court defendants from collaterally attacking state court judgments in federal court. At its broadest, *Huffman* could overrule *Monroe v. Pape*, precluding the federal plaintiff from challenging any state statute in federal court without first applying to the state courts for relief. *Redhail* and *Wooley*, however, indicate clearly that the Court in *Huffman* did not intend the latter result. Therefore, the *Huffman* exhaustion requirement poses an annoying, but not insurmountable, obstacle to the federal civil rights litigant.

The exhaustion requirement is troublesome because it further complicates and obscures an already complex procedural doctrine. Although "Our Federalism" is an important concept in the federal constitutional system, individual civil rights are at least as important. These civil rights are being threatened by technical complexities which make it increasingly difficult to reach the federal forum. Moreover, the rules governing *Younger* extension are at least paradoxical, and at most inconsistent. In any event, they are unpredictable. With the *Younger* decision, the Court took a broad sweep with the paint brush. With each succeeding decision, it comes closer and closer to painting itself into a corner.

Comment

Revised Trial Rule 59 and *P-M Gas*

*The Honorable Jonathan J. Robertson**

Bridging the gap between trial and appeal has been, at times, a frustrating and difficult task for the prospective appellant. Once again, the methodology of the step is undergoing review by the Indiana Supreme Court Advisory Committee on Revision of Rules of Practice and Procedure to make Trial Rule 59 comport with *P-M Gas & Wash Co. v. Smith.*[1] An examination of past rules reveal that the procedure has broken down periodically from either overuse or overly strict application, thereby requiring the drafting of a new rule to correct defects discovered in the day-to-day application of the procedure.

I. A Historical Labyrinth

At early common law, Indiana followed the English method of appellate practice whereby a judgment at law could only be attacked by *a writ of error.*[2] In such a case, the appellant filed the writ with a court of chancery. The ensuing order, if granted, would mandate the trial court to prepare and deliver the record to the court of appeals and would grant a commission to the appellate court to act on the matter.[3] The appellate court only examined questions of law in reviewing writs of error issued by the chancery court.[4] In contrast, the appellate court could review judgments of equity courts by *appeal* only.[5] The appellate court could examine issues of fact as well as law on appeal.[6]

Before and after the writ of error procedure was abolished in favor of an appellate system, appellate counsel had the difficult task of

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*Judge, Indiana Court of Appeals. A.B., Indiana University, 1954; J.D., Vanderbilt University, 1961.

The author extends his appreciation to Fred Miller and Bob Beasley for their assistance in preparing this Comment.

[1]375 N.E.2d 582 (Ind. 1978), *discussed in* Harvey, *Civil Procedure and Jurisdiction, 1979 Survey of Recent Developments in Indiana Law,* 13 Ind. L. Rev. 57, 81-85 (1980) [hereinafter cited as Harvey, *1979 Survey*]; Harvey, *Civil Procedure and Jurisdiction, 1978 Survey of Recent Developments in Indiana Law,* 12 Ind. L. Rev. 42, 67-68 (1979).

[2]A. Iglehart, Pleadings and Practice 419-20 (1879).

[3]*Id. See, e.g.,* Deputy v. Tobias, 1 Blackf. 311 (Ind. 1824).

[4]A. Iglehart, *supra* note 2, at 419-20.

[5]*Id.*

[6]*Id.*

deciding which matters were properly a part of the record without filing a bill of exceptions. Generally, all written documents such as pleadings and motions were a part of the record, whereas written evidentiary documents or oral testimony were not included.[7] The supreme court's policy of excluding certain questionable matters from review by omitting them from the record did not escape criticism:

> There has been no little confusion in the practice in the supreme court in determining what is properly in the record in a given cause. . . . [T]he court seems to have favored that rule which would exclude from the record everything doubtful. Whether this is wise, it would hardly be profitable to inquire, but rulings of this class have frequently resulted in a failure of justice to the client for want of legal discrimination not possessed by the average attorney.[8]

The supreme court also required that documents properly of record had to be *copied* in the transcript; accordingly, originals in the record were disregarded.[9]

The bill of exceptions was another area of bewildering complexity. The bill of exceptions was designed to bring matters into the record which were not included as a matter of course.[10] Unless certain matters were made part of the record by filing a bill of exceptions in a timely manner, an objection based on such matters would not be reviewed, although the matters had been accurately copied into the record by the clerk.

The supreme court strictly enforced the technical requirements for a bill of exceptions. For example, a document which lacked a formal caption denoting the document as a bill of exceptions was insufficient to preserve error, even when the document had been certified by the trial court and judge.[11] Moreover, matters in the bill would not be considered without a showing in the record that a party had filed the bill with the clerk after it had been signed by the judge.[12] The supreme court additionally held that a bill of exceptions which correctly *referred* to the pages in the transcript where the evidence was located was inadequate to present error; instead, such

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[7] *Id.* at 422-24.

[8] *Id.* at 424.

[9] L. Ewbank, A Manual of Practice in the Supreme and Appellate Courts of Indiana § 116, at 240 (2d ed. 1915).

[10] *See generally* 3 F. Wiltrout, Indiana Practice §§ 2271-2272, 2275 (1967); 4 Works' Indiana Practice §§ 62.6-.8 (4th ed. C. Lowe 1952) [hereinafter cited as Works' 4th ed.].

[11] Knickerbocker Ice Co. v. Lewis, 160 Ind. 494, 497, 67 N.E. 188, 189 (1903).

[12] Venezini v. Morrissey, 161 Ind. 391, 392, 68 N.E. 682, 682 (1903).

evidence had to be physically embraced within the bill of exceptions.[13] Furthermore, although a motion for a new trial was properly of record without a bill of exceptions, factual averments contained in the motion did not become part of the record unless they were incorporated in a proper bill of exceptions.[14] Also, a bill of exceptions which concluded that it contained all of the "testimony" in a given cause saved nothing for review because such a conclusion was not the equivalent of a statement that the bill contained all of the "evidence."[15] Conversely, matters which *were* properly part of the record without a bill of exceptions could not be brought *into* the record by a bill of exceptions.[16]

In large measure, however, the confusion concerning documentary matters was eliminated by the following statute:

> Matters that are part of the record without a bill of exceptions.—Every pleading, motion in writing, report, deposition or other paper filed or offered to be filed, in any cause or proceeding, whether received by the court, refused or stricken out, shall be a part of the record from the time of such filing or offer to file. Any order or action of the court in respect to any such pleading, motion in writing, report, deposition or other paper, and every exception thereto taken by any party, shall be entered by the clerk on the minutes or record of the court, and the same, when so entered, shall be a part of the record without any bill of exceptions. Every oral motion, and the ruling of the court thereon and the exceptions taken thereto, shall be entered upon the record or minutes of the court and shall be a part of the record without any bill of exceptions: Provided, That nothing herein shall be construed to prevent the bringing into or putting into the record by proper bill or bills of exceptions any matter which, under the common laws, would not be a part of the record without a bill of exceptions.[17]

The current rules of procedure also obviate the need for bringing the evidence into the record by a bill of exceptions.[18]

The stringent requirements for attacking a judgment demonstrate that the task of merely presenting the events of a trial could

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[13]Blessing v. Blair, 45 Ind. 546 (1874).

[14]Hopkins v. Greensburg, Knightstown, & Clarksburg Turnpike Co., 46 Ind. 187, 195 (1874).

[15]Gazette Printing Co. v. Morss, 60 Ind. 153, 157 (1877).

[16]Wilson v. State, 156 Ind. 631, 635-36, 59 N.E. 380, 392 (1901).

[17]IND. CODE ANN. § 2-3104 (Burns repl. 1968) (repealed effective 1970).

[18]IND. R. APP. P. 7.2. *See also* Registration & Management Corp. v. City of Hammond, 151 Ind. App. 471, 280 N.E.2d 327 (1972).

not be taken lightly. In addition, appellate counsel had to grope through an absurd procedural maze in seeking post-judgment relief. At early common law, the jury's verdict was deemed conclusive and could only be challenged by a proceeding to attaint.[19] To mitigate the harshness of a proceeding to attaint, the common law began to recognize both a motion for a new trial, whenever "injustice had been done,"[20] and a writ of venire de novo, which was a writ requesting a reexamination of the facts for some error in the trial proceedings.[21] Although both the writ and the motion requested the same remedy—a new trial, the two proceedings differed mechanically. A venire de novo was the proper method of attack when a defect appeared on the face of the record, whereas a motion for a new trial addressed matters which were not part of the record.[22] Thus, if a jury returned a general verdict without determining an issue for or against either party, a venire de novo would be proper because the defect was present on the face of the record.[23] If, however, the jury or court made special findings of facts, the presumption that facts which had not been found were not proven could be controverted only by matters outside the record, such as the transcript of the evidence. Hence, the facts could be attacked only by a motion for a new trial.[24]

The frustration resulting from post-judgment practice prior to the adoption of the modern rules generally involved the interplay of the motion for a new trial and the assignment of errors. Upon a writ of error in the early common law, all errors would be reviewed even though such errors were also grounds for a new trial.[25] Nevertheless, the supreme court held that if the asserted error was a proper cause for a new trial, the error must be asserted as such to

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[19]A proceeding to attaint was a product of English common law:

> This inquiry was made by a grand assise or jury of twenty-four persons, usually knights, and, if they found the verdict a false one, the judgment was that the jurors should become infamous, should forfeit their goods and the profits of their lands, should themselves be imprisoned, and their wives and children thrust out of doors, should have their houses razed, their trees extirpated, and their meadows plowed up, and that the plaintiff should be restored to all that he lost by reason of the unjust verdict.

BLACK'S LAW DICTIONARY 116 (5th ed. 1979) (citing W. BLACKSTONE, 3 COMMENTARIES ON THE LAWS OF ENGLAND 402-04 (1768)).

[20]Lowry v. Indianapolis Traction & Terminal Co., 77 Ind. App. 138, 144, 126 N.E. 223, 225 (1920).

[21]Bosseker v. Cramer, 18 Ind. 44, 46 (1862).

[22]*Id.* at 46-47; Lowry v. Indianapolis Traction & Terminal Co., 77 Ind. App. at 150, 126 N.E. at 227.

[23]Maxwell v. Wright, 160 Ind. 515, 518-20, 67 N.E. 267, 268-69 (1903).

[24]*See* Graham v. State *ex rel.* Board of Comm'rs, 66 Ind. 386 (1897).

[25]A. IGLEHART, *supra* note 2, at 428-29.

be properly before the court on appeal.[26] Under this requirement, the overruling of the motion for a new trial served as the assigned error.[27] In *State ex rel. Foster v. Swarts*,[28] the supreme court stated the now familiar purpose of this requirement:

> It does not appear that the plaintiff moved the Court for a new trial. This was essential to enable the Court to review its own action. . . . It is due to the lower Court that its errors, if any, should be pointed out there, so that it may retrace its steps while the record is yet under its control. Without a motion for a new trial, the attention of that Court is not called to its own errors. It is not apprised of what they are. That motion was essential to bring any of the questions arising in the trial, before us . . . .[29]

Another recurring problem for appellate counsel was the necessity of determining which errors fell within the parameters of the eight statutory causes for a new trial.[30] The early notion that only errors which could be remedied by a new trial—those errors occurring during the course of the trial—was incorrect.[31] With respect

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[26]*See, e.g.*, Todd v. State, 25 Ind. 212 (1865); Stump v. Fraley, 7 Ind. 679 (1856).

[27]*See, e.g.*, Ferrenburg v. Studabaker Turnpike Co., 37 Ind. 251 (1871); Caldwell v. Asbury, 29 Ind. 451 (1868).

[28]9 Ind. 221 (1857).

[29]*Id.* at 222 (citation omitted).

[30]The statutory causes for a new trial were:

> First. Irregularity in the proceedings of the court, jury or prevailing party, or any order of court, or abuse of discretion, by which the party was prevented from having a fair trial.
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> Second. Misconduct of the jury or prevailing party.
>
> Third. Accident or surprise, which ordinary prudence could not have guarded against.
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> Fourth. Excessive damages.
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> Fifth. Error in the assessment of the amount of recovery, whether too large or too small, where the action is upon a contract, or for the injury or detention of property.
>
> Sixth. That the verdict or decision is not sustained by sufficient evidence, or is contrary to law.
>
> Seventh. Newly-discovered evidence, material for the party applying, which he could not, with reasonable diligence, have discovered and produced at the trial.
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> Eighth. Error of law occurring at the trial and excepted to by the party making the application; and the court, in granting new trials, may allow the same at the costs of the party applying therefor, or on the costs abiding the event of the suit, or a portion of the costs, as the justice and equity of the case may require, taking into consideration the causes which may make such new trial necessary.

IND. CODE ANN. § 2-2401 (Burns repl. 1968) (repealed effective 1970).

[31]L. EWBANK, *supra* note 9, § 39, at 84-85.

to an irregularity in the proceedings, a motion for a new trial would include erroneous rulings on proceedings for a continuance and rulings on motions to suppress depositions.[32] The overruling of a motion alleging that a special judge was selected in an erroneous manner also required assignment as a cause for a new trial.[33] When a default judgment was entered, however, error with respect to a change of judge had to be independently assigned as error because a new trial was impossible.[34]

Matters relating to a change of venue had to be alleged in a motion for a new trial.[35] Because a petition for removal resembles a motion for a change of venue in that both matters are collateral to the merits, Indiana courts required that any error relating to the petition be asserted in a motion for a new trial.[36] On the other hand, if the court permitted an amendment to the pleadings, even during the course of trial, the error relating to the petition had to be assigned independently.[37]

The courts zealously enforced this rigid system of classifying errors according to the statutory causes for a new trial. With respect to tort damages, only the fourth statutory cause, excessive damages,[38] was available to raise an error,[39] even when an error was based on incorrect instructions.[40] The fifth statutory cause, involving errors in damage amounts,[41] embraced tort actions only when the alleged error was inadequate damages.[42] Cases based on breach of contract or detention of property could also qualify under the fifth statutory clause, provided the recovery was allegedly too large or too small.[43]

The sixth ground, which provided "[t]hat the verdict or decision is not sustained by sufficient evidence, or is contrary to law,"[44] required an allegation that the verdict or decision was contrary to law

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[32]*Id.*, § 41, at 85-86. *See also* 4 WORKS' 4th ed., *supra* note 10, §§ 61.27-.28, at 29-30.

[33]Walb v. Eshelman, 176 Ind. 253, 260, 94 N.E. 566, 569 (1911).

[34]Goodrich v. Stangland, 155 Ind. 279, 284-85, 58 N.E. 148, 150 (1900).

[35]Horton v. Wilson, 25 Ind. 316, 317-18 (1865).

[36]Southern Ry. Co. v. Sittasen, 166 Ind. 257, 260, 76 N.E. 973, 974 (1906).

[37]Reed v. Light, 170 Ind. 550, 567, 85 N.E. 9, 16 (1908).

[38]IND. CODE ANN. § 2-2401 (Burns repl. 1968).

[39]4 WORKS' 4th ed., *supra* note 10, § 61.69, at 59-60. *See, e.g.* Finster v. Wray, 131 Ind. App. 303, 313-14, 164 N.E.2d 660, 665 (1960) (allegation that recovery of tort damages was "too large" insufficient to present error).

[40]4 WORKS' 4th ed., *supra* note 10, § 61.72, at 61.

[41]IND. CODE ANN. § 2-2401 (Burns repl. 1968).

[42]4 WORKS' 4th ed., *supra* note 10, § 61.77, at 64.

[43]*Id.*, § 61.78, at 65 (allegation that damages were "excessive" improper).

[44]IND. CODE ANN. § 2-2401 (Burns repl. 1968) (repealed effective 1970).

or not sustained by sufficient evidence. An allegation that the verdict or decision was contrary to the evidence, however, did not satisfy the sixth ground.[45] Moreover, "decision" was not synonymous with "judgment" under this statutory ground.[46] Consequently, the use of the word "judgment" in alleging the same to be contrary to law or not sustained by sufficient evidence was not a cognizable error under the statute.[47]

Not to be outdone by the procedures of moving for a new trial, the process of assigning errors became a procedural morass without logical support. Consider the following statements by Ewbank:

> It is only rulings of a final character that can properly be assigned as error on appeal. Any ruling which the trial court retains authority to correct must be presented to that court for review in a proper manner before the appeal is taken, or it will not be reviewed on appeal. Therefore, erroneous rulings which are causes for a new trial can not be assigned as error.[48]
>
> . . . .
>
> The sufficiency of a paragraph of pleading must be tested by a demurrer, the rulings of the court at the trial must be presented for review by a motion for a new trial, the sufficiency of the verdict must be tested by a motion for a venire de novo, and the judgment must be attacked by a motion to set it aside or to modify it, before the errors which might be reached in that manner will be considered by an appellate tribunal; and the assignment of errors must refer, not to the original error, but to the ruling of the court when it was presented in an appropriate manner for its consideration.[49]

Thus, erroneous conclusions of law were reviewable only if a proper exception were made, and an error was *independently* assigned because a motion to modify the judgment or a motion for a new trial would not reach the issue.[50] In contrast, a judgment which did not conform to the conclusions of law could only be attacked by a motion to modify the judgment.[51] Moreover, if the answers to special inter-

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[45] 4 WORKS' 4th ed., *supra* note 10, § 61.84, at 71-72.

[46] *Id.*, § 61.82, at 68.

[47] *Id.*, § 61.84, at 70-71. *See, e.g.*, Adkins v. State, 234 Ind. 81, 123 N.E.2d 891 (1955).

[48] L. EWBANK, *supra* note 9, § 134, at 285 (footnote omitted).

[49] *Id.*, § 136, at 289.

[50] Nelson v. Cottingham, 152 Ind. 134, 137, 52 N.E. 702, 702-03 (1899).

[51] *Id.* at 136, 52 N.E. at 702.

rogatories were inconsistent with the general verdict, a motion for a new trial was improper, and the question could only be preserved by an independent assignment of error on the overruling of a motion for a judgment notwithstanding the general verdict.[52] These are only a few of the examples illustrating the ludicrous requirements for assigning error.[53]

By revising Indiana Supreme Court Rule 2-6[54] in 1949, the supreme court eliminated the confusion by permitting all errors arising up to the filing of a motion for a new trial to be asserted in such a motion. This practice was optional; errors which previously could have been assigned independently could still be assigned as such.[55]

In 1960, the rule was revised to mandate the raising of errors in the motion for a new trial.[56] If the error were properly assignable in a motion for a new trial, the error would not be reviewed if assigned independently[57] or if not first presented in the motion for new trial.[58] Thus, when the appellant assigned as error the identical grounds presented in the motion for a new trial, no issue was before the court because the errors could only be presented by assigning error in the overruling of the motion for a new trial.[59] When a motion for a new trial was filed, the asserted errors in the motion could be preserved *only* by assigning as error the overruling of the motion:

> It has been a cause of regret to us that so many cases which are brought to this court, on which, frequently, much labor has been bestowed in their preparation, and in some of which error plainly appears, must be disposed of without our

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[52]Inland Steel Co. v. Harris, 49 Ind. App. 157, 160, 95 N.E. 271, 272 (1911).

[53]For matters properly assigned independently, see L. EWBANK, *supra* note 9, §§ 39, 133, 136; 3 F. WILTROUT, *supra* note 10, § 2388, at 207-10; 4 WORKS' 4th ed., *supra* note 10, § 61.120, at 106 n.2. As to errors which had to be assigned as grounds for a new trial under former practice, see 4 WORKS' 4th ed., *supra* note 10, §§ 40-49a; 5 WORKS' INDIANA PRACTICE § 90.16, at 134-35 (5th ed. A. Bobbitt 1979).

[54]Ind. Sup. Ct. R. 2-6 (Burns Supp. 1959) (1949 revision).

[55]The 1949 revision was discussed in 4 WORKS' 4th ed., *supra* note 10, § 70.73, at 651:

> [T]his affords a safe and sure method of saving all questions presented in the trial court on appeal. All that is required is to specify each ruling of the trial court from the commencement of the action to the filing of the motion for a new trial as one of the grounds for a new trial. When the motion for a new trial is overruled, an assignment of error that the court erred in overruling such motion will present all of the questions on appeal.

[56]Ind. Sup. Ct. R. 2-6 (Burns repl. 1967) (1960 revision).

[57]Wilson v. State, 247 Ind. 454, 456, 217 N.E.2d 147, 149 (1966); Brown v. Harding, 136 Ind. App. 678, 682, 204 N.E.2d 680, 682 (1965).

[58]Denton v. State, 246 Ind. 155, 158, 203 N.E.2d 539, 540 (1965); Parker v. State, 243 Ind. 482, 483, 185 N.E.2d 727, 727 (1962).

[59]Payne v. State, 243 Ind. 400, 186 N.E.2d 9 (1962).

> being able to reach the merits of the controversy. . . . In order to bring before us all the questions presented in the motion for a new trial, it was simply necessary for the appellants to say, in the assignment of errors, that the court erred in overruling the motion for a new trial. Instead, however, of doing that, the appellants have, in the assignment, set forth certain reasons for which, if well founded, the court might have granted a new trial, but which present to this court no question whatever.[60]

In sum, the task of appealing a case in Indiana has been fraught historically with pitfalls precluding even the most worthy appeals.[61]

II. Trial Rule 59: One Step Out of the Maze?

Although Supreme Court Rule 2-6 represented an effort to streamline the procedure of seeking different types of relief from a trial court judgment, the illogic of filing a new motion for a new trial when a party was seeking relief other than a new trial influenced the adoption of Trial Rule 59.[62] Trial Rule 59 provides that a party seeking post-judgment relief must file a motion to correct errors.[63] By filing a motion to correct errors, a party can seek many types of relief in addition to a new trial.[64] Logically, a motion to correct

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[60]Ferrenburg v. Studabaker Turnpike Co., 37 Ind. 251, 252 (1871) (citations omitted).

[61]Other early procedural quirks included the right to a new trial as a matter of right in disputes concerning land. *See, e.g.*, Studabaker v. Alexander, 179 Ind. 189, 100 N.E. 10 (1912). The *Studabaker* court stated that the statute was anomalous, that it should be strictly construed, and that it was derived from the English policy of the sanctity of real estate. *Id.* at 192-93, 100 N.E. at 11. Another procedural pitfall concerned the impropriety of a motion for a new trial after a motion in arrest of judgment. *See, e.g.*, McKinney v. Springer, 6 Ind. 453 (1855); Howard v. State, 6 Ind. 444 (1855).

[62]4 W. Harvey, Indiana Practice 113 (Civil Code Study Commission Comments). *See* Indiana & Mich. Elec. Co. v. Louck, 243 Ind. 17, 20-21, 181 N.E.2d 855, 856 (1962) (prior to adoption of new trial rules in 1970).

[63]Ind. R. Tr. P. 59.

[64]Ind. R. Tr. P. 59(I) provides in part:

> The court, if it determines that prejudicial or harmful error has been committed, shall take such action as will cure the error, including without limitation the following with respect to all or some of the parties and all or some of the issues:
>
> (1) Grant a new trial;
> (2) Enter final judgment;
> (3) Alter, amend, modify or correct judgment;
> (4) Amend or correct the findings or judgment as provided in Rule 52(B);
> (5) In the case of excessive or inadequate damages, enter final judgment

errors, instead of a motion for a new trial, is a prerequisite for appealing a trial court judgment under the trial rules.[65]

Despite the logical appeal of Trial Rule 59, new procedural problems have impeded a party's entry into the appellate court system. Until recently amended, Trial Rule 59(C) provided that "a motion to correct errors shall be filed not later than sixty [60] days after the entry of judgment."[66] This rule arguably required a motion to correct errors after the entry of every judgment. Professor Grove recently identified the absurdity of this requirement:

> Following the trial court's entry of judgment, one of the parties files a timely motion to correct errors; in the course of its ruling on the motion, the trial court enters a new judgment. Should a second motion to correct errors addressed to the judgment be required as a prerequisite to appeal? According to Appellate Rules 4(A) and 2(A) the answer would seem to be "no": the ruling on the motion is "deemed" to be the "final judgment" from which a timely appeal may be perfected. Trial Rule 59(C), however, suggests the necessity of a motion to correct errors directed to the new "entry of judgment." . . . [I]t is plausible to conclude that any error occurring prior to the time when a motion addressed to the new judgment could be filed must be specified in such motion, including error already set forth in the motion to correct errors directed to the original judgment.[67]

Nevertheless, the Indiana Supreme Court in *Deprez v. State*[68]

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on the evidence for the amount of the proper damages, grant a new trial, or grant a new trial subject to additur or remittitur;

(6) Grant any other appropriate relief, or make relief subject to condition; or

(7) In reviewing the evidence, the court shall grant a new trial if it determines that the verdict of a nonadvisory jury is against the weight of the evidence; and shall enter judgment, subject to the provisions herein, if the court determines that the verdict of a nonadvisory jury is clearly erroneous as contrary to or not supported by the evidence, or if the court determines that the findings and judgment upon issues tried without a jury or with an advisory jury are against the weight of the evidence.

This provision was formerly Trial Rule 59(E).

[65]Bradburn v. County Dep't of Pub. Welfare, 148 Ind. App. 387, 390, 266 N.E.2d 805, 806 (1971); Ind. R. Tr. P. 59(G) (altered in amended version of trial rule).

[66]Ind. R. Tr. P. 59(C). The amended version of Trial Rule 59(C) replaces old Trial Rules 59(C) and 59(G). *See* Ind. R. Tr. P. 59(C).

[67]Grove, *The Requirement of a Second Motion to Correct Errors as a Prerequisite to Appeal*, 10 Ind. L. Rev. 462, 463 (1977).

[68]260 Ind. 413, 296 N.E.2d 120 (1973), *overruled*, P-M Gas & Wash Co. v. Smith, 375 N.E.2d 592 (Ind. 1978). For a further discussion of *DePrez*, see notes 74-75 and accompanying text.

adopted the requirement of a second motion to correct errors after the trial court enters a new judgment.[69]

The supreme court overruled *Deprez* in *P-M Gas & Wash Co. v. Smith*[70] by adopting several procedural rule changes eliminating the second motion requirement. The *P-M Gas* court made critical changes in the process of filing "motions to correct errors, cross-errors, and the various rights of appeal on assignment of error."[71]

The following essential facts are crucial for understanding the substantive changes made in *P-M Gas*: (1) Smith filed a personal injury suit against P-M Gas. The jury returned a verdict for P-M Gas; (2) Smith filed a motion to correct errors. Although the trial court overruled certain specifications, it sustained one ground and ordered a new trial; (3) P-M Gas filed a motion to correct errors which was denied; (4) At the appellate level, Smith, the appellee, assigned cross-errors in his brief concerning questions raised in his original motion to correct errors, which the trial court had overruled; and (5) P-M Gas, the appellant, moved to strike Smith's cross-errors for failure to comply with Trial Rule 59(D) which, according to P-M Gas, required Smith to file cross-errors within fifteen days after P-M Gas's motion to correct errors.

On transfer, the supreme court considered a two-pronged argument that the court of appeals had erred in striking the cross-errors in Smith's appellee brief: (1) P-M Gas unnecessarily filed a motion to correct errors. Because the motion was unnecessary, Smith was not required to file cross-errors under Trial Rule 59(D); and (2) Trial Rule 59(D) applies only to a motion filed on evidence outside the record.

P-M Gas essentially argued for the necessity of filing a subsequent motion to correct errors by an aggrieved party when a prior motion is granted in part and a new trial is ordered. The supreme court observed that P-M Gas was caught in a "procedural quagmire"[72] created by the court's own "initial judicial error"[73] in *Deprez*.[74] Admitting that the *Deprez* ruling was erroneous, the court explained:

> In *Deprez*, the trial court in a long standing condemnation action entered a judgment against the state, *dismissing with prejudice*. The state filed a motion to correct error,

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[69]*See* 260 Ind. at 420, 296 N.E.2d at 124.

[70]375 N.E.2d 592 (Ind. 1978).

[71]*Id.* at 597.

[72]*Id.* at 593.

[73]*Id.* at 597.

[74]For a discussion of many of these appellate court cases, see Grove, *supra* note 67.

> after which the trial court set forth, for the first time, findings of fact and conclusions of law and entered a judgment of dismissal which is a final judgment. The state then directly appealed without a second motion to correct error addressed to the "new judgment" and this Court agreed with the appellee in that case that the appeal should be dismissed because the state had not filed a second motion to correct error. The designation of the second judgment of *dismissal with prejudice* as "new" did not make it more final than the original judgment of *dismissal with prejudice*.
>
> That conclusion was incorrect, and it and the *Deprez* cases are overruled herewith.[75]

The supreme court held that the requirement of a second motion to correct errors was error because Appellate Rule 4(A)[76] "states that a trial court's ruling on a motion to correct error shall be deemed the 'final judgment' from which appeal is to be taken."[77] The court observed that Appellate Rule 4(A) accords with Appellate Rule 2(A)[78] involving the initiation of an appeal and Appellate Rule 7.2(A)(1)[79] concerning the inclusion of documents in the record.[80] Moreover, according to the court, Trial Rule 59(G)[81] did not require a second mo-

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[75]375 N.E.2d at 594.

[76]IND. R. APP. P. 4(A) provides in part:

> Appeals may be taken by either party from all final judgments of Circuit, Superior, Probate, Criminal, Juvenile, County, and where provided by statute for Municipal Courts. A ruling or order by the trial court granting or denying a motion to correct errors shall be deemed a final judgment, and an appeal may be taken therefrom.

[77]375 N.E.2d at 594.

[78]IND. R. APP. P. 2(A) states:

> An appeal is initiated by filing with the clerk of the trial court a praecipe designating what is to be included in the record of the proceedings, and that said praecipe shall be filed within thirty (30) days after the court's ruling on the Motion to Correct Errors or the right to appeal will be forfeited. A copy of such praecipe shall be served promptly on the opposing parties.

[79]IND. R. APP. P. 7.2(A)(1) states:

> The record of the proceedings shall consist of the following documents:
>
> (1) A certified copy of the motion to correct errors or an assignment of errors.
>
> (a) In all appeals from a final judgment, a certified copy of the motion to correct errors filed with the trial court shall constitute for all purposes the assignment of errors. No assignment of error other than the motion to correct errors shall be included in the record.
>
> (b) In all appeals from interlocutory orders, there shall be included instead of the certified copy of the motion to correct errors a specific assignment of the errors alleged.

[80]375 N.E.2d at 594.

[81]Ind. R. Tr. P. 59(G) provided:

tion, notwithstanding suggestive language otherwise.[82] The court flatly declared in *P-M Gas*: "One motion for each party or *each appellant, if there is more than one, shall be sufficient*. . . . Once it is made and acted upon, whatever action the trial court takes, then the items specified in that motion, and the trial court's disposition constitute the basis for the appellant's appeal."[83] In short, the court ruled

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In all cases in which a motion to correct errors is the appropriate procedure preliminary to an appeal, such motion shall separately specify as grounds therefor each error relied upon however and whenever arising up to the time of filing such motion. Issues which could be raised upon a motion to correct errors may be considered upon appeal only when included in the motion to correct errors filed with the trial court. A motion to correct errors shall not be required in the case of appeals from interlocutory orders, orders appointing or refusing to appoint a receiver, and from orders in proceedings supplemental to execution.

[82]375 N.E.2d at 595.

[83]*Id.* The *P-M Gas* court elaborated on these points as follows:

IV. [IND. R. APP. P.] 4(A) should be read as allowing either party to appeal a ruling on a motion to correct error, and the principles of law on 'finality' are well stated in [3 W. HARVEY, INDIANA PRACTICE § 54.2 (Supp. 1978)].

V. If a party seeks to raise error which occurred at trial, or afterward in a verdict or judgment, then [Ind. R. Tr. P.] 59(G), second sentence, requires that party to make a motion to correct error. Once made, no second motion should ever be required from that party.

(A) If a party wants to complain about the relief granted to another party, when that other party made a motion to correct error which was granted in whole or in part, then that party can appeal that order, and commence the process under [IND. R. APP. P.] 2(A).

(B) This would not require that party to make a motion to correct error in his own right. In that way, that party then becomes an appellant, and the regular appeal process obtains.

(C) It is often the case that an appellee will not raise trial error in the appellate court, and will only answer the appellant's positions and brief. If so, then it is not necessary for the appellee to file a motion to correct error in the trial court.

VI. If the appellant, on the other hand, is a party who seeks to reinstate a jury verdict, for example, after it was received by the appellant but changes as a result of a motion to correct error by the appellee, who now defends the final judgment entered, it is not necessary for that appellant to file a motion to correct error, if appellant does not raise error himself. If appellant seeks reinstatement of that jury verdict because it was incorrect for the trial court to have granted the appellee's motion to correct error, then it is not necessary for the appellant to do more than request relief on brief in the appellate court. The "complaint on appeal" will be measured, in such an example, by the original verdict and judgment and the motion to correct error filed by the appellee *and* the favorable relief given to that motion by the trial court.

VII. If the appellant maintains that there was error, he can say that on brief and explain why, after he has initiated the appeal under the Indiana Rules of Appellate Procedure.

VIII. Of course, if trial was to the court, and the trial court first

that an appellant does not have to file a second motion to correct errors if he has raised the error in a previous motion.[84]

With this foundation established, the court held that the cross-errors raised in Smith's brief should not have been dismissed for failure to comply with Trial Rule 59(D) because he raised the cross-errors in his original Trial Rule 59 motion.[85] Disagreeing with the lower appellate court's interpretation,[86] the supreme court simply stated that Trial Rule 59(D) "only covers matters *dehors* the record."[87] Nothwithstanding the Trial Rule 59(D) situation, the court acknowledged that cross-appeals are not addressed in Indiana's rules of procedure. The court took the initiative to develop a set of rules for cross-appeals.[88] According to the court, the second sentence of Trial Rule 59(G),[89] which eliminated the need to file a second motion to correct errors after the motion is made, applied to a *cross-appellant*.[90] In addition, the court ruled that

> [i]f an appellee desires to become a cross-appellant, then he must make that decision within sixty days after the entry of the judgment in his favor, pursuant to [Trial Rule] 59(C). When that has been done, then the ruling which is made on that motion to correct error becomes the "complaint on the cross-appeal." Thereafter, the rules of appellate procedure apply, and in that regard . . . it might not be necessary to file a praecipe if, as therein, the original praecipe filed covered the entire record.[91]

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entered a judgment for the appellant and then changed it on appellee's motion to correct error, the same process would result as in the example when the trial was to the jury.

IX. If each party makes a motion to correct error, then each can raise the ruling on that motion and the ruling on the other party's motion on appeal as cross-errors, respectively.

X. If a party does not make a motion to correct error, he has nothing belonging to him which can be appealed, unless, of course, he is harmed if the other party moves to correct error and the motion is granted in some aspect.

375 N.E.2d at 596-97.

[84]375 N.E.2d at 595.

[85]*Id.*

[86]352 N.E.2d at 92, *quoted in* 375 N.E.2d at 595.

[87]375 N.E.2d at 596.

[88]Chief Justice Givan and Justice Pivarnik disagreed with the majority's rule-making-by-opinion approach. *Id.* at 598 (Givan, C.J., Pivarnik, J., concurring).

[89]The second sentence of Ind. R. Tr. P. 59(G) stated: "Issues which could be raised upon a motion to correct errors may be considered upon appeal only when included in the motion to correct errors filed with the trial court."

[90]375 N.E.2d at 596.

[91]*Id.* The court relied on Seco Chemicals, Inc. v. Stewart, 349 N.E.2d 733 (Ind. Ct. App. 1976). In *Seco*, the Indiana Court of Appeals held that once an appellant filed its

The court also held that when both parties move to correct errors, each party "can raise the ruling on that motion and the ruling on the other party's motion on appeal as cross-errors respectively."[92]

Since *P-M Gas*, the Indiana Supreme Court and Courts of Appeals have construed and applied several aspects of the new procedural rules enunciated by *P-M Gas*. The supreme court found certain *P-M Gas* principles controlling in two recent cases, *Bridge v. Board of Zoning Appeals*[93] and *Indiana Revenue Board v. State ex rel. Board of Commissioners*.[94]

In *Bridge*, the supreme court observed that the detailed findings of fact made by the trial court in granting the appellant's request for these findings in his motion to correct errors "expanded upon, but did not alter, the substance of the original decision."[95] "The errors to be presented on appeal," the court wrote, "were stated in the original motion to correct errors and the basis for them was not affected by the subsequent entry of findings of fact."[96] The court of appeals had dismissed the appeal because no second motion to correct errors was filed. Because the court of appeals relied on *Deprez*, which was overruled by *P-M Gas*, the supreme court granted transfer and remanded *Bridge* for a decision on the merits.[97]

Similarly, the supreme court granted transfer in *Indiana Revenue Board*, which had been dismissed by the court of appeals due to the revenue board's failure to file a second motion to correct errors after the trial court amended the amount of its judgment awarded to a number of Indiana counties in a class action suit. The supreme court held pursuant to *P-M Gas* that a second motion was not needed "as the same justiciable issues were completely expressed within the original motion."[98]

In both cases, the original judgment was neither altered nor amended by the motion to correct errors, at least not to such an extent that the errors to be presented on appeal were affected. The supreme court's language, however, suggests that a different result might obtain when the substance of an original decision is altered upon the trial court's ruling on a motion to correct errors. Indeed,

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praecipe, thereby invoking appellate jurisdiction, Appellate Rule 2(A) was satisfied, and a cross-appellant was not required to made a separate filing of a praecipe to preserve the appellate issue. The appellant in *Seco* included the entire record in the praecipe. *Id.* at 739.

[92]375 N.E.2d at 597.

[93]381 N.E.2d 1060 (Ind. 1978), *referred to in* Harvey, *1979 Survey*, *supra* note 1, at 82.

[94]385 N.E.2d 1131 (Ind. 1979).

[95]381 N.E.2d at 1060.

[96]*Id.*

[97]*Id.* at 1060-61.

[98]385 N.E.2d at 1132.

the question remains whether the supreme court in subsequent *P-M Gas* cases has created an exception to the one-motion rule of *P-M Gas* which will require a second motion in an appropriate case. The short answer would seem to be "no" inasmuch as the reviewing court would have to overrule explicit *P-M Gas* language mandating only one motion;[99] three justices apparently adhere to this rule.[100] The view is not without dissent, however. Chief Justice Givan, concurring in the *P-M Gas* result, expressed his preference for a rule requiring "that any time a judgment is substantially modified no appeal may be taken from that judgment unless a motion to correct errors is filed."[101] Chief Justice Givan concluded that he would not have overruled the *Deprez* line of cases.[102]

Subsequent decisions of the Indiana Court of Appeals have also strictly applied the *P-M Gas* rules. Recently, in *DeHart v. Anderson*,[103] the court delineated the parameters of the issues to be considered on appeal in view of *P-M Gas*. The plaintiff-appellee Anderson filed a motion to correct errors questioning the trial court's entry of a judgment upon the defendant-appellant DeHart's motion to dismiss, which had been granted. The trial court granted the appellee's motion to correct errors and ordered the case to be set for trial. DeHart then appealed from the ruling without filing his own motion to correct errors. The court of appeals implicitly held that an appellant can appeal the determination in favor of an appellee's motion to correct errors without filing his own motion and can seek reinstatement of the trial court judgment.[104] Citing *P-M Gas*, the court held that the issues raised by DeHart were "determined by the judgment dismissing the cause, the motion to correct errors, and the trial court's ruling on the motion [to correct errors]."[105]

In *Schmal v. Ernst*,[106] the defendant Ernst's petition for release of escrow money held by the trial court clerk was denied. Ernst then filed a motion to correct errors alleging as error the court's failure to release the money. Schmal did not contest the release but requested that it be credited against a $12,500 judgment. The trial

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[99]*See* note 83 *supra* and accompanying text.

[100]Justices DeBruler and Prentice concurred in Hunter's majority opinion. 375 N.E.2d at 598.

[101]*Id.* (Givan, C.J., concurring).

[102]*Id.* (Givan, C.J., concurring).

[103]383 N.E.2d 431 (Ind. Ct. App. 1978), *cited in* Harvey, *1979 Survey, supra* note 1, at 83.

[104]*See* 383 N.E.2d at 434.

[105]*Id.*

[106]387 N.E.2d 96 (Ind. Ct. App. 1979), *discussed in* Harvey, *1979 Survey, supra* note 1, at 83.

court granted the motion to correct errors and ordered that the money be released to Ernst; however, the money was not to be credited against the judgment. Schmal appealed from the order by filing a praecipe and an appellate brief with the belief that he was appealing from an interlocutory order.[107] On appeal, Ernst contended that the order sustaining the motion to correct errors was a final judgment requiring Schmal to file a motion to correct errors to preserve error.

Without reaching the question whether the order was interlocutory or final, the court of appeals held that, in any event, Schmal followed the proper procedure to preserve error in view of this *P-M Gas* language:

> "(A) If a party wants to complain about the relief granted to another party, when that other party made a motion to correct error which was granted in whole or in part, then that party can appeal that order, and commence the process under [Appellate Rule] 2(A).
>
> (B) This would not require that party to make a motion to correct error in his own right. In that way, that party then becomes an appellant, and the regular appeal process obtains."[108]

The court of appeals also relied on other *P-M Gas* language:

> "It is not necessary for that appellant to file a motion to correct error if appellant does not raise error himself. If appellant seeks [only to appeal the favorable relief given to appellee] because it was incorrect . . . then it is not necessary for the appellant to do more than request relief on brief in the appellate court."[109]

The court of appeals decided that Schmal was not required to file a motion to correct errors because the only error alleged was the failure to apply the escrow money against the judgment.[110]

Two appellate decisions have avoided the harshness of retroactive application of *P-M Gas* by determining that under the law existing prior to *P-M Gas*, the proper procedure was to file an additional motion to correct errors. In *Estate of Holderbaum v. Gibson*,[111] the court of appeals held:

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[107]Ind. R. Tr. P. 59(G) did not require a motion to correct errors for interlocutory orders. This exception is preserved under the amended rules in Trial Rule 59(C).

[108]387 N.E.2d at 98 (quoting 375 N.E.2d at 597).

[109]387 N.E.2d at 98 (quoting 375 N.E.2d at 597).

[110]387 N.E.2d at 98.

[111]376 N.E.2d 1189 (Ind. Ct. App. 1978).

> When the trial judge, in the case before us, granted the estate's motion to correct errors, he altered the prior judgment in the most drastic manner possible. He not only vacated the judgment previously entered for Gibson, but also entered a judgment for the estate. The law as it existed at the time the estate's motion was granted very clearly required Gibson to file an additional motion to correct errors in order to preserve her right to appeal.[112]

More recently, in *Nehring v. Raikos*,[113] the trial court amended its judgment on the appellant's first motion to correct errors. The appellant filed his second motion to correct errors when *Deprez* and its progeny were the law. Observing that *Deprez* required the second motion to be directed at the amended judgment, the court of appeals denied the appellee's motion seeking to vacate the trial court orders and dismiss the appeal upon jurisdictional (timing) grounds.[114]

The most significant application of the *P-M Gas* procedure on the court of appeals level was in *State ex rel. Sacks Brothers Loan Co. v. DeBard*.[115] In *DeBard*, the appellee DeBard filed a motion to dismiss, citing Sacks' failure to comply with the statute[116] requiring a transcript to be filed within fifteen days of the administrative decision pursuant to the Indiana Administrative Adjudication Act.[117] The trial court overruled the motion. On appeal, DeBard's motion to correct errors did not cite the trial court's overruling of the motion to dismiss as error. The court of appeals initially raised the question of lack of jurisdiction *sua sponte* in a memorandum opinion and remanded the case for the trial court to dismiss Sacks' appeal from the administrative decision denying a license; Sacks, however, in his petition for rehearing sought reexamination in light of *P-M Gas*.

Upon reconsideration, the court of appeals held that the failure to comply with the Act was a jurisdictional defect which may be waived by a party because the defect did not involve lack of jurisdiction over the subject matter but rather lack of jurisdiction over the particular case.[118] The question of the trial court's jurisdiction in the particular case, therefore, was not preserved on appeal because the appellee failed to file a motion to correct errors as required by *P-M Gas*. In reaching this conclusion, the second district court of appeals relied on the following *P-M Gas* language:

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[112]*Id.* at 1192.

[113]390 N.E.2d 1092 (Ind. Ct. App. 1979).

[114]*Id.* at 1094-95.

[115]381 N.E.2d 119 (Ind. Ct. App. 1978).

[116]IND. CODE § 4-22-1-14 (1976).

[117]*Id.* §§ 4-22-1-1 to -30 (1976).

[118]381 N.E.2d at 120.

> "If an appellee desires to become a cross-appellant, then he must make that decision within sixty days after the entry of the judgment in his favor, pursuant to [Trial Rule] 59(C). When that has been done, then the ruling which is made on that motion to correct error becomes the 'complaint on the cross-appeal.'"[119]

The *DeBard* court explained that "[t]his means, then, that a party (appellee) for whom a judgment ostensibly is rendered must express dissatisfaction with that judgment by filing a motion to correct errors pursuant to Trial Rule 59(C) in order to preserve cross-error on appeal."[120]

III. Through the Looking-Glass

P-M Gas' policy of eliminating the need for multiple motions to correct error has recently prompted the Indiana Supreme Court Advisory Committee on Revision of Rules of Practice and Procedure to propose several trial rule changes to the supreme court, which has rulemaking powers.[121] The committee reported:

> The proposed amendments [to Trial Rule 59] are intended to conform the Rule to *P-M Gas & Wash Co. v. Smith*, . . . which overruled *State v. Deprez* . . . and its progeny, subject, however, to the following qualifications. First, the proposed amendments allow a party to appeal the granting of a motion to correct errors without himself filing a subsequent motion to correct errors, and to raise for the first time in his appellate brief errors that occurred at trial and which the party claims were prejudicial to him. Secondly, the proposed amendments allow a party who is prejudiced by any action taken by the trial court on its own motion during the time for filing a motion to correct errors to appeal that action without the party himself filing a motion to correct errors.[122]

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[119] *Id.* (quoting 375 N.E.2d at 596).

[120] 381 N.E.2d at 120. The court of appeals in Continental Cas. Co. v. Novy, 397 N.E.2d 294 (Ind. Ct. App. 1979), recently treated another case dealing with the *P-M Gas* doctrine. The court decided that the parties have the "discretion to appeal immediately or file a motion to correct errors in those cases where the court has altered, amended or supplemented its findings and/or judgment after the filing of one motion to correct errors." *Id.* at 296.

[121] State *ex rel* Bicanic v. Lake Circuit Court, 260 Ind. 73, 76, 292 N.E.2d 596, 598 (1973); Ind. Code § 34-5-2-1 (1976) (statute conferring rulemaking powers).

[122] Indiana Supreme Court Advisory Committee on Revision of Rules of Practice and Procedure, Synopsis of Proposed Amendments to Trial Rule 59 Motion to Correct Errors 3 (July 1, 1979) (citations omitted).

On November 13, 1979, the Indiana Supreme Court promulgated the new version of Trial Rule 59[123] which among other things, incorporated the two qualifications suggested by the advisory committee. The updated version of Trial Rule 59(E) states: "A party who is prejudiced by any modification or setting aside of a final judgment or an appealable final order following the filing of a motion to correct error may appeal that ruling without filing a motion to correct error."[124] In sum, Trial Rule 59(E) not only conforms to the rules an-

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[123]IND. R. TR. P. 59 (effective January 1, 1980).

[124]IND. R. TR. P. 59(E) (as amended). The committee offered the following comments:

> This section is new, and it speaks to several situations. A party under *P-M Gas* can appeal an adverse determination made on another party's motion to correct errors, without making a motion himself. . . . That remains correct under this section.
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> In addition, any party is allowed to appeal a ruling on a motion to correct errors without making another motion, or a "second" motion to correct errors, see *Bridge v. Board of Zoning Appeals of Ft. Wayne*, 381 N.E.2d 1060 (Ind. 1978). This provision is consistent with that holding, and rule.
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> (1) Under this provision, if the appellant received a judgment and the appellee made a motion to correct errors against that judgment which the trial court granted, and entered judgment against the appellant (or a lesser form of relief), then the appellant can appeal the granting of the motion to correct errors without making a motion himself and the appellant can ask for the reinstatement of the judgment which was set aside in the trial court as a result of the motion to correct errors. That was the factual setting in *DeHart v. Anderson*, 383 N.E.2d 431, 433-434 (Ind. App. 1978), in which the Court of Appeals pointed out that the issues on appeal were determined by: (1) the judgment dismissing the cause (which occurred in the case), (2) the motion to correct errors, and (3) the trial court's ruling on the motion. The provision is also consistent with the procedural facts and law in *Schmal v. Ernst*, 387 N.E.2d 96 (Ind. App. 1979).
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> (2) It is the intention of the Committee to change one of the holdings in *P-M Gas*, in this section. In *P-M Gas* the Court stated "[that] it is not necessary for that appellant to file a motion to correct error if appellant does not raise error himself. If appellant seeks [only to appeal the favorable relief given to appellee] because it was incorrect . . . then it is not necessary for the appellant to do more than request relief on brief in the appellate court." 375 N.E.2d at 597.
>
> It is the Committee's judgment that *P-M Gas* has altered the traditional rule that a party must first specifically present error to the trial court for an opportunity for correction and only then can that party raise the error on appeal. That rule has been altered to the extent that an appealing party can raise error in the appellate court by appealing the trial court's ruling on a motion to correct error without making a motion to correct error too.
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> The Committee recommends that this principle be extended to the situation identified in the examples set out below.
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> The Committee recommends that this provision be interpreted to allow an appellant in this situation to appeal not only the granting of the motion to correct error, which would be raised on brief as set out in *P-M Gas*, but the

nounced in *P-M Gas* and its progeny but also extends the liberal principles advocated by the supreme court. The trial rule possesses the novel feature of allowing an appellant to raise errors occurring at trial on brief which have not been raised on a motion to correct errors.[125]

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appellant should be allowed to raise those errors which occurred at trial on brief in the appellate court too.

For example: X received a judgment as the plaintiff in an action against Y, but two rulings were made against X on the admissibility of evidence which caused X's evidence to be excluded. X properly preserved the questions at trial, by an offer to prove. Y made a motion to correct error against X's judgment, and had a judgment entered for Y, the defendant, and now appellee, on that motion.

It is the Committee's recommendation that X be allowed to appeal the entry of the motion to correct error, and raise, in addition, the two claimed errors which adversely affected X at trial, without making a motion to correct errors to that effect. In this way, that part of *P-M Gas* would be changed, and the limitation on issues on appeal found in *DeHart v. Anderson*, 383 N.E.2d 431, 433-434 (Ind. App. 1979) would be changed too.

In such a situation as the one confronting X in this appeal, it might be the case that the appellate court, and X too, believes that X's original judgment cannot be reinstated. Nevertheless, X might be entitled to a new trial because of the alleged trial court error, and can show the appellate court that error and ask for that relief, in the alternative, in X's appeal to the appellate court. The Committee believes that X should be able to make that appellate claim without filing a motion to correct error as a predicate for making it.

Of course, under this provision it will be necessary for the appellant to have objected to the ruling at trial which was adverse to the appellant. In that way the trial court has had an opportunity to examine the issue and rule; the Committee believes that is sufficient and that it need not recur in the trial court, and can be raised on brief by the appellant herein described.

To further demonstrate the intention of the Committee, the Committee considered but rejected the following language:

> "If a party seeks relief on appeal from error which is claimed to have occurred prior to or in the trial court's entry of a judgment, or an appealable final order, that party must have filed a motion to correct error directed to the error which is claimed."

The Committee preferred a more liberal system of raising errors on appeal, if it is the appellant who raises that error, and hence rejected the provision set out.

INDIANA SUPREME COURT ADVISORY COMMITTEE ON REVISION OF RULES OF PRACTICES AND PROCEDURE, COMMITTEE NOTES ON TRIAL RULE 59 [hereinafter cited as COMMITTEE NOTES].

[125]COMMITTEE NOTES, *supra* note 124. This result will arise in situations where the appellant receives a judgment against the appellee at the trial court level and the appellee files a motion to correct errors. If the trial court grants the appellee's motion overturning the appellant's judgment, the appellant not only may challenge the unfavorable determination in favor of appellee's motion but also may raise errors that occurred during trial on brief without filing any motion to correct errors. *See id.*

Although the elimination of the need for multiple motions to correct errors is a significant step, perhaps the most telling aspect of the new rule is its intent to provide "a more liberal system of raising errors on appeal."[126] Although not as readily documented, the same motivation could have prompted the progression of changes over the years in smoothing the gap between trial and appeal. Even though the new rule retains the traditional requirement of "making a record" at the trial level, a concern must exist on the appellate level for the consequences of a rule that purportedly eases entry into the appeals system and the subsequent result, if any, on an already constantly increasing caseload. Additionally, when a change in the trial rules occurs, the ultimate result of the change is not fully realized until judicial interpretation has occurred. The course of pervasive liberality in raising errors on appeal in this instance is, as yet, uncharted and will undoubtedly be subject to numerous perils before the outcome will be fully realized.

Thus, the practitioner contemplating an appeal should exercise restraint in issue selection. One may reasonably predict a judicial backlash if the bar seizes upon the opportunity to use the newly won liberality concept as a dumping ground for appeals comprised of less than meritorious questions. Although the court of appeals may not openly refuse to apply the new trial rule, the court may rely on other procedural devises to eliminate frivolous appeals that threaten to clog the overtaxed intermediate appellate system. Considering the possibility of a judicial backlash, an attorney should file a motion to correct errors to preserve errors on appeals rather than rely on his ability to raise these matters on brief. An overburdened court of appeals is likely to undercut the liberal spirit of new Trial Rule 59, if attorneys abuse the right to raise matters on brief. Given the collective ingenuity of the bench and the bar and the past history of this procedural area, one can only wonder how long the new rule will serve its intended purpose. Indeed, the adoption of this trial rule may mark the beginning of a new adventure "through the looking glass." The tortured history of the procedure for perfecting an appeal continues to unfold.

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[126] *Id.*

Notes

Nonmutuality: Taking the Fairness out of Collateral Estoppel

I. Introduction

The scope of collateral estoppel has undergone an evolutionary expansion. Collateral estoppel, a doctrine which precludes unnecessary relitigation of issues, was limited until recently by a requirement of mutuality in nearly every jurisdiction. Thus, collateral estoppel was applied only if both parties were mutually bound by the previous judgment; if one party was not bound, then neither was bound.[1]

Mutuality was abandoned in California in 1942 when the California Supreme Court allowed a defendant who had not been a party to the first suit to estop a plaintiff who had previously lost on the same issue.[2] Many jurisdictions have joined rank in permitting a nonparty defendant to estop a losing plaintiff from relitigating, but few jurisdictions have granted the same privilege to a nonparty plaintiff. Most opinions discussing nonmutual collateral estoppel have hinged upon whether application of the doctrine would be unfair to the estopped party.

A distinction between defendant-asserted collateral estoppel—defensive use of collateral estoppel—and plaintiff-asserted collateral estoppel—offensive use of collateral estoppel—has gradually developed. The distinction may be described as follows:

> [O]ffensive use of collateral estoppel occurs when the plaintiff seeks to foreclose the defendant from litigating an issue the defendant has previously litigated unsuccessfully in an action with another party. Defensive use occurs when a defendant seeks to prevent a plaintiff from asserting a claim the plaintiff has previously litigated and lost against another defendant.[3]

Offensive use is feared to increase litigation and cause unfairness to defendants; therefore, some courts have limited nonmutual collateral estoppel to defensive use.[4]

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[1] F. James & G. Hazard, Civil Procedure § 11.24 (2d ed. 1977).

[2] Bernhard v. Bank of America Nat'l Trust & Sav. Ass'n, 19 Cal. 2d 807, 122 P.2d 892 (1942).

[3] Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n.4 (1979).

[4] *See, e.g.*, Standage Venture, Inc. v. State, 114 Ariz. 480, 562 P.2d 360 (1977); Spettigue v. Mahoney, 8 Ariz. App. 281, 445 P.2d 557 (1968); Tezak v. Cooper, 24 Ill. App. 2d 356, 164 N.E.2d 493 (1960); Albernaz v. Fall River, 346 Mass. 336, 191 N.E.2d 771 (1963).

In 1979, the Supreme Court in *Parklane Hosiery Co. v. Shore*[5] discarded a defensive limitation upon nonmutual collateral estoppel and, finding no unfairness, permitted a nonparty plaintiff to estop a losing defendant.[6] Fairness instead of mutuality now limits the application of collateral estoppel in federal courts.

This Note will trace the abandonment of mutuality and explore the modern doctrine of collateral estoppel, emphasizing the federal test of unfairness as formulated in *Parklane*.[7] Application of collateral estoppel without mutuality, termed "nonmutuality,"[8] will be examined for its effects upon the objectives of collateral estoppel. The test of procedural unfairness, applicable to all cases of collateral estoppel, will be assessed. Additional considerations unique to offensive nonmutuality—lack of incentive to litigate vigorously, availability of joinder, and inconsistent judgments—will be discussed.

II. The Demise of Mutuality

A. *Mutuality as a Traditional Prerequisite*

Res judicata is often confused with collateral estoppel. Although both doctrines preclude relitigation, they are significantly different in the type of relitigation precluded. Res judicata precludes relitigation of identical *suits*; collateral estoppel precludes relitigation of identical *issues* in different suits. Only issues actually litigated and essential to a valid and final judgment are subject to collateral estoppel.[9]

Traditionally, courts have limited the scope of collateral estoppel by requiring identity of parties and mutuality of judgment.[10] The

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[5]439 U.S. 322 (1979).

[6]*Id.* at 332-33.

[7]*Id.* at 331-33.

[8]For the purposes of this Note, "nonmutuality" represents the assertion of collateral estoppel by a litigant who was not a party to and thus was not bound by the original litigation. "Offensive nonmutuality" denotes assertion of collateral estoppel by a nonparty plaintiff; "defensive nonmutuality" denotes assertion of collateral estoppel by a nonparty defendant.

[9]Restatement (Second) of Judgments § 88, comment a (Tent. Draft No. 3, 1976).

[10]The term "mutuality" is commonly used to encompass the requirements of identical parties and mutual judgment. Mutuality has been explained in the following way: "The doctrine of mutuality requires that, as a general proposition, one who invokes the conclusive effect of a judgment must have been either a party or his privy to the suit in which the judgment was rendered. Stated differently, the mutuality requirement prevents a litigant from invoking the conclusive effect of a judgment unless he would have been bound if the judgment had gone the other way." 1B Moore's Federal Practice ¶ 0.412[1] [hereinafter referred to as 1B Moore's]. *See also* Clyde v. Hodge, 413 F.2d 48, 51 (1969) (using "identity of parties" and "mutuality" interchangeably). The requirements are, however, distinct. *See, e.g.*, State v. Speidel, 392 N.E.2d 1172 (Ind. Ct. App. 1979).

two requirements are generally coextensive[11] because of the binding nature of judgments; a judgment concludes a lawsuit and binds the parties to that lawsuit.[12] For example, when parties in the second suit were parties to the first suit, thus satisfying the requirement of identical parties, mutuality is also satisfied because both parties are bound by the earlier judgment. When the parties are identical and judgment is mutual, the parties are estopped from relitigating issues decided in the first suit.[13]

If the second action involves different parties, however, collateral estoppel cannot be applied because the judgment is not mutually binding.[14] For example, a party who did not previously litigate with an adversary, and thus was not bound by a prior judgment, cannot use collateral estoppel against that adversary.

Mutuality was founded upon a theory of evenhandedness. The nonparty would not have been bound by a determination in favor of the original party; therefore, the nonparty should not be permitted to use an unfavorable judgment against the original party.[15] To have allowed a nonparty the benefit of a judgment that was not earned by litigation and to which the nonparty could not have been bound seemed inequitable. Consequently, courts required mutuality of judgment to preclude assertion of collateral estoppel by nonparties.

Over the years, a general exception to mutuality developed in situations of derivative liability.[16] Courts granted defensive collateral estoppel without mutuality to a nonparty defendant whose liability had been derived from another defendant exonerated in a prior action brought by the same plaintiff.[17] The derivative liability

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[11] *But see* State v. Speidel, 392 N.E.2d 1172 (Ind. Ct. App. 1979). Although the parties were identical in both suits, mutuality did not exist. A representative of the plaintiffs won a wrongful death action against the state. In a second action, the plaintiffs sued for their own injuries. The court of appeals reasoned that the plaintiffs would not have been bound by a finding in the first suit that the state was not negligent; therefore, they could not take advantage of the finding of negligence under the mutuality rule in Indiana. *Id.* at 1177-78. The court reluctantly denied collateral estoppel and suggested for future judicial consideration that mutuality be waived in the rare instances in which mutuality does not exist although parties are identical. *Id.* at 1179-80.

[12] *See* F. JAMES & G. HAZARD, *supra* note 1, § 11.2.

[13] State v. Speidel, 392 N.E.2d 1172, 1175 (Ind. Ct. App. 1979).

[14] *Id.* at 1177.

[15] Semmel, *Collateral Estoppel, Mutuality and Joinder of Parties*, 68 COLUM. L. REV. 1457, 1470-71 (1968).

[16] 1B MOORE'S, *supra* note 10, ¶ 0.412[3].

[17] *See, e.g.*, Bigelow v. Old Dominion Copper Co., 225 U.S. 111, 127-28 (1912). Liability is derivative in relationships between principal and agent, indemnitor and indemnitee, and employer and employee. Adriaanse v. United States, 184 F.2d 968 (2d Cir. 1950), illustrates the derivative liability exception. The plaintiff unsuccessfully sued his employer, a steamship company, and later sued the United States on the same

exception allowed courts to avoid secondary liability in the absence of primary liability.[18]

B. The Trend Toward Nonmutuality

Weakened by the derivative liability exception, the strict rule of mutuality was toppled in California in *Bernhard v. Bank of America National Trust & Savings Association*.[19] It had been determined in a probate action that the testator intended a gift by transfer of certain funds. The estate administrator subsequently was estopped from suing the nonparty bank for the same funds.[20] Finding no justification for mutuality, Justice Traynor explained:

> The criteria for determining who may assert a plea of res judicata differ fundamentally from the criteria for determining against whom a plea of res judicata may be asserted. The requirements of due process of law forbid the assertion of a plea of res judicata against a party unless he was bound by the earlier litigation . . . . There is no compelling reason, however, for requiring that the party asserting the plea of res judicata must have been a party, or in privity with a party, to the earlier litigation.[21]

The *Bernhard* decision started a trend of nonmutual collateral estoppel. Although many jurisdictions still cling to the mutuality rule,[22] perhaps a slight majority now permit estoppel in the absence

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issue of negligence. The original judgment was not binding on the United States, which had not been a party. Despite a lack of mutuality, the court found an agency relationship and allowed the United States as principal to use the former judgment for its agent against the plaintiff. The court relied on " '[a]n apparent exception to . . . mutuality . . . where the liability of the defendant is altogether dependent upon the culpability of one exonerated in a prior suit, upon the same facts when sued by the same plaintiff.' " *Id.* at 969 (citing Bigelow v. Old Dominion Copper Co., 225 U.S. at 127-28 (1912)).

[18]1B MOORE'S, *supra* note 10.

[19]19 Cal. 2d 807, 122 P.2d 892 (1942).

[20]*Id.* at 814, 122 P.2d at 896.

[21]*Id.* at 811-12, 122 P.2d at 894. Justice Traynor apparently confused the terms "collateral estoppel" and "res judicata." *See* text accompanying note 8 *supra*.

[22]Cases in which the courts have adhered to mutuality include: Suggs v. Alabama Power Co., 271 Ala. 168, 123 So. 2d 4 (1960); Hogan v. Bright, 214 Ark. 691, 218 S.W.2d 80 (1949); Daigneau v. National Cash Register Co., 247 So. 2d 465 (Fla. 1971); Porterfield v. Gilmer, 132 Ga. App. 463, 208 S.E.2d 295 (1974); State v. Speidel, 392 N.E.2d 1172 (Ind. Ct. App. 1979); Keith v. Schiefen-Stockham Ins. Agency, Inc., 209 Kan. 537, 498 P.2d 265 (1972); Barnett v. Commonwealth, 348 S.W.2d 834 (Ky. 1961); Howell v. Vito's Trucking & Excavating Co., 386 Mich. 37, 191 N.W.2d 313 (1971); Pace v. Barrett, 205 So. 2d 647 (Miss. 1968); Feinstein v. Edward Livingston & Sons, Inc., 457 S.W.2d 789 (Mo. 1970); Vincent v. Peter Pan Bakers, Inc., 182 Neb. 206, 153 N.W.2d 849 (1967); Atencio v. Vigil, 86 N.M. 181, 521 P.2d 646 (1974); King v. Grindstaff, 284 N.C. 348, 200 S.E.2d 799 (1973); Armstrong v. Miller, 200 N.W.2d 282 (N.D. 1972).

of mutuality.[23] Most jurisdictions discarding mutuality have emphasized that estoppel must be denied unless the defendant was afforded a full and fair opportunity to litigate in the previous suit.[24] Some courts have further limited nonmutuality to defensive as opposed to offensive use.[25]

Usually the party to be estopped is in the same adversary position in both suits.[26] Occasionally, however, positions change: An original defendant may later sue as plaintiff,[27] a former plaintiff may subsequently become a defendant,[28] or codefendants may later become adversaries.[29] Courts have been more willing to allow nonmutual estoppel defensively against a common plaintiff in these gray areas than in strict offensive situations involving multiple suits against a common defendant.[30]

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[23]Cases in which the courts have sanctioned nonmutual estoppel include: Pennington v. Snow, 471 P.2d 370 (Alaska 1970); Standage Ventures, Inc. v. State, 114 Ariz. 480, 562 P.2d 360 (1977); Murphy v. Northern Colo. Grain Co., 30 Colo. App. 21, 488 P.2d 103 (1971); Ellis v. Crockett, 51 Haw. 45, 451 P.2d 814 (1969); Tezak v. Cooper, 24 Ill. App. 2d 356, 164 N.E.2d 493 (1960); Goolsby v. Derby, 189 N.W.2d 909 (Iowa 1971); Pat Perusse Realty Co. v. Lingo, 249 Md. 33, 238 A.2d 100 (1968); Home Owners Fed. Sav. & Loan Ass'n v. Northwestern Fire & Marine Ins. Co., 354 Mass. 448, 238 N.E.2d 55 (1968); Thill v. Modern Erecting Co., 284 Minn. 508, 170 N.W.2d 865 (1969); Paradise Palms Community Ass'n v. Paradise Homes, 89 Nev. 27, 505 P.2d 596, *cert. denied*, 414 U.S. 865 (1973); Sanderson v. Balfour, 109 N.H. 213, 247 A.2d 185 (1968); Desmond v. Kramer, 96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967); Hart v. American Airlines, Inc., 61 Misc. 2d 41, 304 N.Y.S.2d 810 (Sup. Ct., Special Term 1969); Hicks v. De La Cruz, 52 Ohio St. 2d 71, 369 N.E.2d 776 (1977); Anco Mfg. & Supply Co. v. Swank, 524 P.2d 7 (Okla. 1974); Bahler v. Fletcher, 257 Or. 1, 474 P.2d 329 (1970); Richards v. Hodson, 26 Utah 2d 113, 485 P.2d 1044 (1971); Simpson Timber Co. v. Aetna Cas. & Sur. Co., 19 Wash. App. 535, 576 P.2d 437 (1978); McCourt v. Algiers, 4 Wis. 2d 607, 91 N.W.2d 194 (1956).

[24]*See* RESTATEMENT (SECOND) OF JUDGMENTS § 88, Reporter's Note (Tent. Draft No. 3, 1976); Note, *Collateral Estoppel: The Changing Role of the Rule of Mutuality*, 41 MO. L. REV. 521, 529 (1976).

[25]*See* note 4 *supra* and accompanying text.

[26]*See* Currie, *Mutuality of Estoppel: Limits of the* Bernhard *Doctrine*, 9 STAN. L. REV. 281 (1957).

[27]The following cases have permitted nonmutual estoppel of a former defendant who later as the plaintiff sued a nonparty defendant: Goolsby v. Derby, 189 N.W.2d 909 (Iowa 1971); Paradise Palms Community Ass'n v. Paradise Homes, 89 Nev. 27, 505 P.2d 596, *cert. denied*, 414 U.S. 865 (1973); Bahler v. Fletcher, 257 Or. 1, 474 P.2d 329 (1970).

[28]A former plaintiff was estopped in a subsequent action in which he was a defendant in Hardware Mut. Ins. Co. v. Valentine, 119 Cal. App. 2d 125, 259 P.2d 70 (1953).

[29]Estoppel has been permitted in second suits between original codefendants, thus encouraging the filing of crossclaims. Desmond v. Kramer, 96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967); Simpson Timber Co. v. Aetna Cas. & Sur. Co., 19 Wash. App. 535, 576 P.2d 437 (1978); McCourt v. Algiers, 4 Wis. 2d 607, 91 N.W.2d 194 (1956).

[30]*See* Currie, *supra* note 26, at 289.

Hesitancy to apply collateral estoppel offensively stems from judicial fear that offensive use will increase litigation and cause unfairness to defendants.[31] Courts rejecting, as well as those accepting, offensive nonmutuality have found support in the ambiguity of the *Bernhard* opinion,[32] which addressed only defensive estoppel.[33]

Several federal and state decisions have granted offensive use to successive plaintiffs who were victims of a mass accident,[34] such as an airplane crash. Additional examples of offensive use include a defendant employer estopped from relitigating an employment contract interpretation,[35] a municipal defendant estopped from denying hospital ownership previously determined,[36] and a defendant vendor estopped from relitigating the existence of an enforceable sales contract.[37] The latter two decisions did not characterize the collateral estoppel as being applied offensively and seem indicative of a trend toward de-emphasizing an offensive-defensive distinction as suggested by the *Restatement (Second) of Judgments*.[38]

C. *The Supreme Court View*

The growing volume of cases granting offensive use of nonmutual collateral estoppel indicates a judicial shift toward rejection

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[31]*See, e.g.*, Reardon v. Allen, 88 N.J. Super. 560, 571-73, 213 A.2d 26, 32 (Super. Ct. Law Div. 1965).

[32]The Third Circuit has restricted the *Bernhard* doctrine to defensive use in permitting estoppel in an analogous surety situation. Bruszewski v. United States, 181 F.2d 419, 422 (3d Cir.), *cert. denied*, 340 U.S. 865 (1950). A district court in Maryland extended *Bernhard* to offensive use in allowing subsequent plaintiffs to estop the common defendant on the issue of negligence. Maryland v. Capital Airlines, Inc., 267 F. Supp. 298, 303 (D. Md. 1967). In California, several lower court opinions declined to apply the *Bernhard* doctrine to offensive use situations. Price v. Atchison, T. & S.F. Ry., 164 Cal. App. 2d 400, 330 P.2d 933 (1958); Nevarov v. Caldwell, 161 Cal. App. 2d 762, 327 P.2d 111 (1958). *See also* notes 176-79 *infra* and accompanying text.

[33]Collateral estoppel in *Bernhard* was used by a second defendant against a losing plaintiff. Justice Traynor remarked: "[I]t would be unjust to permit one who has had his day in court to reopen identical issues by merely switching adversaries." 19 Cal. 2d at 813, 122 P.2d at 895. Justice Traynor was apparently thinking of defensive use, because only a plaintiff, by choosing to sue defendants in succession, may switch adversaries. A defendant who is sued by successive plaintiffs has not chosen to switch adversaries because he has no control over the filing of suits. Although reflective of defensive use, *Bernhard* did not distinguish between defendant-asserted and plaintiff-asserted collateral estoppel.

[34]*See* Maryland v. Capital Airlines, Inc., 267 F. Supp. 298 (D. Md. 1967); United States v. United Airlines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962); Desmond v. Kramer, 96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967); Hart v. American Airlines, Inc., 61 Misc. 2d 41, 304 N.Y.S.2d 810 (Sup. Ct., Special Term 1969).

[35]Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir. 1964).

[36]Hicks v. De La Cruz, 52 Ohio St. 2d 71, 369 N.E.2d 776 (1977).

[37]Richards v. Hodson, 26 Utah 2d 113, 485 P.2d 1044 (1971).

[38]RESTATEMENT (SECOND) OF JUDGMENTS § 88, Reporter's Note (Tent. Draft No. 2, 1975), *discussed in* Parklane Hosiery Co. v. Shore, 439 U.S. 322, 330 n.13 (1979).

of a defensive limitation. The Supreme Court recently added its approval to this shift in *Parklane Hosiery Co. v. Shore*,[39] refusing to limit the federal doctrine of collateral estoppel to defensive use.[40]

The defendants, Parklane Hosiery Company and its directors, were originally sued by the Securities and Exchange Commission for making materially false and misleading statements regarding a merger; a declaratory judgment was entered to that effect.[41] Shore, a plaintiff stockholder claiming damages in a later suit, was permitted to estop the defendants on the identical issue of falsity.[42]

In granting offensive nonmutuality, the Supreme Court determined that the defendant suffered no unfairness by application of the doctrine.[43] The *Parklane* opinion examined the following factors in its determination of fairness: (1) Whether the plaintiffs could have joined in the first suit; (2) whether the defendant had incentive to litigate vigorously; (3) whether the judgment relied upon is inconsistent with a previous judgment in favor of the defendant; and (4) whether the defendant had full procedural opportunities in the first suit.[44] The *Parklane* decision formulated a general rule for federal courts: "[W]here a plaintiff could easily have joined in the earlier action or where, either for the reasons discussed above or for other reasons, the application of offensive estoppel would be unfair to a defendant, a trial judge should not allow the use of offensive collateral estoppel."[45] The Supreme Court went on to find no violation of the seventh amendment right to jury trial,[46] a topic beyond the scope of this Note.

The federal rule of nonmutuality had originated eight years earlier in *Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation*.[47] The Supreme Court granted *defensive* nonmutuality in allowing a nonparty defendant accused of patent infringement to use an earlier declaration of patent invalidity against the losing plaintiff patent holder.[48] The Court in *Blonder*, however, specifically limited its discussion to defensive use in patent invalidity cases.[49] Although most federal courts permitted nonmutuality after *Blonder*, many re-

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[39]439 U.S. 322 (1979).

[40]*Id.* at 331.

[41]Securities & Exch. Comm'n v. Parklane Hosiery Co., 422 F. Supp. 477, 487 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083, 1085 (2d Cir. 1977).

[42]439 U.S. at 332-33.

[43]*Id.* at 332.

[44]*Id.*

[45]*Id.* at 331.

[46]*Id.* at 333.

[47]402 U.S. 313 (1971).

[48]*Id.* at 350.

[49]*Id.* at 330.

mained confused about the viability of a defensive limitation.[50] The *Blonder* decision therefore left the federal view of nonmutuality unresolved.

The Supreme Court in *Parklane* dictated the discretionary application of nonmutual collateral estoppel in federal cases and dispelled limitations of patent invalidity or defensive use as may have been inferred from *Blonder*.[51] According to the opinion in *Parklane*, nonmutuality is limited only by fairness to the estopped party.[52]

III. The Effects of Nonmutuality on the Objectives of Collateral Estoppel

A. *In General*

An evaluation of the application of collateral estoppel without mutuality demands assessment of its effects upon the objectives of collateral estoppel. The basic purpose of collateral estoppel is to avoid needless relitigation, which is also reflected in such litigation-saving devices as joinder, counterclaims, intervention, and interpleader.[53]

Avoiding relitigation achieves underlying goals of preventing parties from having more than one day in court, protecting parties from the burden of relitigation, and reducing court time in the interests of judicial economy.[54] Nonmutuality fails to serve the latter two goals. Moreover, its adverse effect upon judicial economy contributes to the unpopularity of offensive use.

B. *The Limit of One Day in Court*

Collateral estoppel is founded on the premise that a party should not be allowed to reopen an issue that he has already had an opportunity to litigate.[55] Limiting a party to one opportunity appears equitable to all concerned. In view of today's crowded dockets, such a limit seems fair to the overworked judiciary and to "other litigants who might have to wait to have their day in court because

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[50] *See, e.g.*, Federal Sav. & Loan Ins. Corp. v. Hogan, 476 F.2d 1182, 1187 (7th Cir. 1973).

[51] 439 U.S. at 331.

[52] *Id.*

[53] *See* Fed. R. Civ. P. 18-22, 24.

[54] The Supreme Court in *Parklane* recognized judicial economy and protection from burdensome relitigation as the dual purposes of collateral estoppel. 439 U.S. at 326. The Court discussed the detrimental effect on judicial economy of allowing offensive use, *id.* at 329-30, but ignored its lack of effect on burdensome relitigation.

[55] F. James & G. Hazard, *supra* note 1, § 11.2.

one litigant is allowed to litigate the same issue over and over again."[56]

A one-day limit also seems fair to the estopped party, because due process only entitles a litigant to one day in court.[57] With or without mutuality, due process is satisfied because collateral estoppel requires that the party who is estopped has already litigated the issue. The party has had his day in court. Nonmutuality expands the group of litigants who *may assert* collateral estoppel but does *not* affect the group of litigants who *may be estopped.*

Nonmutuality appears to promote fairness to a greater extent than mutuality. By expanding the scope of the one-day limit, nonmutuality further reduces relitigation which, in turn, increases fairness to the overworked judiciary and waiting litigants.

C. *The Burden of Relitigation*

Another purpose of collateral estoppel is to protect parties from the burden of relitigation.[58] Through collateral estoppel a final judgment is given force to identical issues in subsequent litigation. Prevention of relitigation allows parties to rely upon the original judgment and protects the winner from the burdens of repeated trials, including additional expense and risk of inconsistent judgments.

Under the rule of mutuality, parties who have once litigated are mutually foreclosed from relitigating. If the losing party attempts to relitigate, the winner may estop that party and thus avoid burdensome relitigation. Mutual collateral estoppel therefore furthers the purpose of protecting parties from the burdens of relitigation.

Unlike mutuality, nonmutuality does not protect parties from such a burden because subsequent litigation does not burden either party.[59] By the ability to estop the losing party, the nonparty is not being protected from relitigating because he is litigating for the first time. He was not a party to the previous suit and did not litigate the judgment that he uses. Only relitigation, not initial litigation, is unfairly burdensome. Likewise, the losing party who is estopped by the nonparty requires no protection because relitigation would mean a benefit, not a burden. Despite additional expense, the losing party may prefer to reopen the litigation with the hope of receiving a different judgment. Thus, nonmutuality does not serve the goal of protecting parties from burdensome relitigation.

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[56]Maryland v. Capital Airlines, Inc., 267 F. Supp. 298, 304 (D. Md. 1967).

[57]*See* note 21 *supra* and accompanying text.

[58]439 U.S. at 326.

[59]*See* Reardon v. Allen, 88 N.J. Super. 560, 571, 213 A.2d 26, 32 (Super. Ct. Law Div. 1965).

D. Judicial Economy

Collateral estoppel developed upon a theory of judicial economy.[60] Society has a right to the efficient administration of justice,[61] a concern that has grown increasingly more important as courts have become more crowded. The Federal Rules of Civil Procedure reflect this growing concern in litigation-saving devices such as class actions[62] and joinder.[63] Needless relitigation hampers judicial administration; through preclusion of relitigation, collateral estoppel promotes judicial efficiency.

Collateral estoppel requiring mutuality reduces relitigation between identical parties. Eliminating mutuality expands the scope of collateral estoppel to allow nonparties as well as parties to use a prior judgment to estop a losing party from relitigating. Therefore, nonmutuality seemingly reduces the judicial workload to an even greater extent than mutuality. Nonmutuality indirectly increases the litigation that occurs within original and subsequent suits, however, and in cases of offensive use, increases the total number of suits. To determine the judicial economy of nonmutuality accurately, the relitigation avoided by expanded collateral estoppel must be weighed against the additional litigation it will cause.

1. Increased Litigation Within the Original Suit.—Nonmutuality increases the extent of litigation within the original suit because litigants are indirectly compelled to fight with greater vigor when nonparties as well as parties may later use a judgment. A cautious "litigant may feel bound to fight a case to the utmost in both trial and appellate courts which he would treat rather casually if its sole effect were on the immediate adversaries."[64] A small liability settlement which would have previously satisfied both parties will be litigated to its fullest extent, "contrary to the public interest in minimizing litigation."[65]

In denying offensive collateral estoppel, a New Jersey court in *Reardon v. Allen*[66] observed:

> The threat of collateral estoppel could impede the speedy disposition of smaller claims. More jury trials would be demanded in the county district courts; extensive discovery activities would be generated, with a corresponding increase

[60]*See* Parklane Hosiery Co. v. Shore, 439 U.S. at 326.

[61]*See* Maryland v. Capital Airlines, Inc., 267 F. Supp. 298, 304 (D. Md. (1967).

[62]FED. R. CIV. P. 23.

[63]FED. R. CIV. P. 18-20.

[64]R. FIELD & B. KAPLAN, CIVIL PROCEDURE 859 (3d ed. 1973).

[65]Moore & Currier, *Mutuality and Conclusiveness of Judgments*, 35 TUL. L. REV. 301, 310 (1961).

[66]88 N.J. Super. 560, 213 A.2d 26 (Super. Ct. Law Div. 1965).

> in motions, and depositions taken in the first action would be repeated in each successive action because strangers, without the right of cross-examination, are not bound. More appeals would be taken in an effort to avoid the widespread consequences of an adverse judgment.[67]

Nonmutuality encourages heightened litigation in both offensive and defensive use situations; a plaintiff fears future estoppel by nonparty defendants while a defendant fears future estoppel by nonparty plaintiffs.

Limiting collateral estoppel by a test of fairness appears to exacerbate the problem of exhaustive initial litigation. Under the *Parklane* approach, if a party fully motivated to litigate was given a full and fair procedural *opportunity*,[68] he may be precluded from relitigating;[69] therefore, he is strongly induced to take fullest advantage of the opportunity.

To summarize, offensive and defensive nonmutuality induce exhaustive initial litigation, contrary to the goals of judicial economy. The *Parklane* test further induces such litigation by conditioning estoppel upon the fullness of the opportunity to litigate.

2. Increased Litigation Within Subsequent Suits.—The adoption of fairness as a limitation upon nonmutuality may increase litigation within subsequent suits.[70] Rather than engage in relitigation of issues, parties will contest the application of nonmutual collateral estoppel; to avoid being estopped, a plaintiff or defendant will argue that he did not receive a full and fair opportunity to litigate in the original suit. The focus of litigation thus shifts from the merits to procedural opportunity when nonmutual collateral estoppel is asserted, whether offensively or defensively.[71]

Litigation of procedural opportunity may prove more cumbersome than relitigation of the issues precluded. An observer explained:

> It is arguable . . . that because there is no *certainty* in the application of a full-and-fair-opportunity test nearly every litigant against whom collateral estoppel is asserted will seek to show that he would be prejudiced by a preclusion of his claim. Although trials on the merits would be minimized, the resulting increase in litigation concerning the application

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[67]*Id.* at 572, 213 A.2d at 32.

[68]*See* notes 96-114 *infra* and accompanying text.

[69]439 U.S. at 332.

[70]*See* Blonder-Tongue Laboratories, Inc. v. University of Ill. Foundation, 402 U.S. at 347.

[71]*Id.*

> of collateral estoppel could more than offset any saving of time or expense.[72]

The Supreme Court in *Blonder* admitted that the fairness limitation may increase litigation of the applicability of collateral estoppel but concluded that determination of procedural opportunity is less time-consuming than relitigation of the merits of an issue.[73] Considering the extreme length of most patent litigation,[74] this conclusion seems appropriate when the issue is one of patent invalidity as in *Blonder*.[75] The same may not hold true, however, for less extensive litigation. Relitigating the merits of simple issues may take less time than litigating the application of nonmutuality. By increasing the litigation of applicability, nonmutuality may actually increase litigation within subsequent suits.

3. Increased Number of Suits.—Nonmutuality increases litigation within original and subsequent suits, regardless of whether it is asserted offensively by a plaintiff or defensively by a defendant. The effect of nonmutuality upon the overall number of suits, however, does depend to a great extent upon whether the use of nonmutuality is offensive or defensive. Defensive use encourages fewer suits, which may offset any increase in original and subsequent litigation, but offensive use provokes additional suits.

Defensive use of nonmutual collateral estoppel induces joinder of defendants into one action.[76] In cases of defensive use, a plaintiff who originally loses an issue is subsequently precluded from relitigating the same issue against all defendants, including those not parties to the original suit. Consequently, defensive use motivates a plaintiff to join all potential defendants in one suit to avoid the risk of estoppel forever preventing subsequent litigation with nonparty defendants.[77]

Conversely, offensive use discourages original consolidation of

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[72]Note, *Collateral Estoppel: The Demise of Mutuality*, 52 CORNELL L.Q. 724, 730 (1967). The observer projected that litigation of opportunity would probably consume less time than relitigation of the merits. *Id.*

[73]402 U.S. at 347.

[74]*Id.* at 348.

[75]*Id.*

[76]*See* Parklane Hosiery Co. v. Shore, 439 U.S. at 329-30. For a comparison of the effects on judicial economy of defensive and offensive use, see Note, *The Impacts of Defensive and Offensive Assertion of Collateral Estoppel by a Nonparty*, 35 GEO. WASH. L. REV. 1010 (1967), *cited in* Parklane Hosiery Co. v. Shore, 439 U.S. at 329 n.11.

[77]A plaintiff may join defendants when claims involve the same transaction or occurrence. FED. R. CIV. P. 20. However, jurisdictional requirements must be satisfied. *See generally* F. JAMES & G. HAZARD, *supra* note 1, §§ 12.1-.30.

litigation.[78] Under offensive use, a defendant is precluded from relitigating an issue originally lost against all subsequent plaintiffs. A defendant may wish to join all plaintiffs in the original action to avoid subsequent estoppel, but such joinder is impractical for several reasons. First, a defendant may not be certain who the potential adversaries are. Second, only limited procedural consolidation is available to a defendant.[79] Offensive use thus rarely induces a defendant to join his potential plaintiffs.

Similarly, plaintiffs are not motivated to join in the first action. Plaintiffs may intervene in the initial action[80] but are reluctant to do so as long as they enjoy the possibility of relying upon a predecessor's favorable judgment. If another litigant wins a judgment against the defendant, the waiting plaintiff acquires a favorable judgment free of charge with which to estop the defendant on identical issues. If the defendant wins in a prior suit, the plaintiff who waits has lost nothing; the defendant may not use the judgment against the plaintiff because the plaintiff was not a party to the original suit and thus has not had his day in court as required by due process. Allowing nonparty plaintiffs to use another's judgment induces them to "shrink back, until coerced by the statute of limitations . . . or by other factors, to begin suit, for the claimant who goes first has the most to lose, and the one who goes last the least . . . ."[81] Thus, offensive use induces multiple suits, whereas defensive use induces consolidation of litigation.

E. Summary of the Effects

Nonmutuality advances a policy of fairness in limiting parties to one day in court against all adversaries. It neither aids nor hinders the protection of parties from burdensome relitigation. Nonmutuality contravenes judicial economy, however, especially when asserted

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[78]*See* Parklane Hosiery Co. v. Shore, 439 U.S. at 329-31. *See also* Reardon v. Allen, 88 N.J. Super. at 571-72, 213 A.2d at 32.

[79]A defendant cannot join claimants in federal courts except by necessary joinder if the court decides the plaintiff is an indispensable party, FED. R. CIV. P. 19; by interpleader in the rare situations involving exposure to double liability, FED. R. CIV. P. 22; by consolidation of claims brought in the same jurisdiction, FED. R. CIV. P. 42(a); or by declaratory judgment, if the court permits, FED. R. CIV. P. 57. Many states have adopted procedural rules identical to the federal rules. *See, e.g.*, IND. R. TR. P. 19, 22, 42, 57.

[80]Plaintiffs may join in one action under the rule of permissive joinder if they raise a common issue in asserting a right to relief arising out of the same transaction. FED. R. CIV. P. 20. A plaintiff may intervene in a pending action under the rule of permissive intervention when his claim and the main claim have a common question, as determined by the court in the exercise of its discretion. FED. R. CIV. P. 24(b).

[81]Reardon v. Allen, 88 N.J. Super. at 572, 213 A.2d at 32.

by a nonparty plaintiff. It increases the litigation within original and subsequent suits, but this increase is offset in defensive use by inducing consolidation of suits and thus totally eliminating subsequent litigation. Conversely, offensive use further defeats judicial economy by promoting multiple suits.

Fear of multiple suits contributes to judicial disfavor of offensive use.[82] This multiplicity may be prevented by adherence to a proposal in *Parklane*: plaintiffs who have unjustifiably refused to join in the original suit cannot later use its judgment.[83] If joinder is encouraged by this rule, it will offset additional litigation within the first suit and will totally avoid subsequent suits, similar to defensive nonmutuality.

IV. The Procedural Test of Unfairness

A. *Development of the Fairness Limitation*

Nonmutuality under the *Bernhard* rule proved unworkable in later years. The *Bernhard* opinion reduced collateral estoppel to three requirements: "Was the issue decided in the prior adjudication identical with the one presented in the action in question? Was there a final judgment on the merits? Was the party against whom the plea is asserted a party or in privity with a party to the prior adjudication?"[84]

The California Supreme Court relaxed this rigid formula fifteen years later in *Taylor v. Hawkinson*.[85] Although the requirements of *Bernhard* were satisfied, the court denied collateral estoppel because its application would unfairly give preclusive effect to a compromise verdict.[86]

Most courts abrogating mutuality have emphasized, as did the *Taylor* court, that its application is limited by fairness to the estopped party.[87] Constitutional due process[88] accounts for the emphasis upon

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[82]*Id.* A second major argument against offensive use is that its application may be unfair to the estopped defendant. *See* Parklane Hosiery Co. v. Shore, 439 U.S. at 329-31.

[83]439 U.S. at 331-33. *See also* notes 149-62 *infra* and accompanying text.

[84]19 Cal. 2d at 813, 122 P.2d at 895.

[85]47 Cal. 2d 893, 306 P.2d 797 (1957).

[86]*Id.* at 897, 306 P.2d at 799. *See* note 110 *infra* and accompanying text.

[87]*See, e.g.*, Blonder-Tongue Laboratories, Inc. v. University of Ill. Foundation, 402 U.S. 313, 330 (1971); Rachal v. Hill, 435 F.2d 59, 62 (5th Cir. 1970); Maryland v. Capital Airlines, Inc., 267 F. Supp. 298, 304 (D. Md. 1967).

[88]*See generally* J. Nowak, R. Rotunda, & J. Young, Handbook on Constitutional Law 476-514 (1978). The applicable constitutional provisions are the fifth and fourteenth amendments. The fifth amendment reads: "No person shall . . . be deprived of life, liberty, or property, without due process of law . . . ." U.S. Const. amend. V.

fairness, demanding that courts examine the initial action to insure that the estopped party has actually been given a full and fair opportunity to litigate.[89] Ordinarily, the party to be estopped has the burden of proving that he received less than such a full procedural opportunity.[90]

Although attaining new significance with the advent of nonmutuality, unfairness has always prevented application of collateral estoppel, whether asserted by a former party—mutuality—or a nonparty—nonmutuality.[91] However, fairness in offensive nonmutuality is tested differently from mutuality and defensive nonmutuality.[92] The Supreme Court in *Parklane* recognized differing standards of fairness in stating that "[t]he problem of unfairness is particularly acute in cases of offensive estoppel [without mutuality]."[93]

Fairness cannot be defined with precision; it varies with the circumstances of each case.[94] Only a cluster of factors may be extracted from court opinions to measure the fairness of collateral estoppel. Several factors are unique to offensive nonmutuality.[95]

B. *An Assessment of Procedural Opportunity*

A party who lost in the original suit because he was not given a full and fair opportunity to litigate should not be precluded from relitigating. A court will deny collateral estoppel—mutual or nonmutual—if it decides that the original suit did not give the party to be estopped a procedural opportunity that was both full and fair.

Fullness is determined by comparing the first suit with the second; an opportunity may have been less than full if the second suit afforded procedural privileges unavailable in the first suit. Fairness is determined by examining the first suit for procedural disadvantages which unfairly prevented litigation on the merits. Procedural rules should give neither party an edge because cases should be tried on their merits.[96]

The fourteenth amendment reads: "No State shall . . . deprive any person of life, liberty, or property without due process of the law . . . ." U.S CONST. amend. XIV.

[89]*See* United States v. United Air Lines, Inc., 216 F. Supp. 709, 725-26 (E.D. Wash. 1962).

[90]Maryland v. Capital Airlines, Inc., 267 F. Supp. 298, 304 (D. Md. 1967); B.R. DeWitt, Inc. v. Hall, 19 N.Y.2d 141, 148, 225 N.E.2d 195, 199, 178 N.Y.S.2d 596, 601 (1967); Hart v. American Airlines, Inc., 61 Misc.2d 41, 46, 304 N.Y.S.2d 810, 813 (Sup. Ct. Special Term 1969).

[91]Sanderson v. Balfour, 109 N.H. 213, 216, 247 A.2d 185, 187 (1968).

[92]*See* text accompanying notes 115-90 *infra*.

[93]439 U.S. at 331 n.15.

[94]United States v. United Air Lines, Inc., 216 F. Supp. 709, 726 (E.D. Wash. 1962).

[95]*See* notes 121-23 *infra* and accompanying text.

[96]*See* Foman v. Davis, 371 U.S. 178, 181-82 (1962).

Factors which courts have considered to determine procedural opportunity include the following: Choice of forum,[97] availability of jury trial,[98] differences between administrative and civil proceedings,[99] differences in evidentiary rules,[100] availability of procedural devices such as discovery[101] and counterclaims,[102] adequacy of representation,[103] availability of new evidence,[104] opportunity to call witnesses,[105] length of trial,[106] jury prejudice,[107] compromise verdicts,[108] and differences in available law.[109]

Procedural disadvantages are weighed to determine whether they justify denial of collateral estoppel. Judicial evaluation of compromise verdicts and jury trial availability illustrate the test of procedural opportunity.

Taylor, a case of mutual collateral estoppel, is typical of the heavy weight usually accorded compromise verdicts. An auto accident was the focus of a prior suit in which an occupant, owner, and driver of one car sued the driver of another car. Judgment was given for the plaintiffs, but the plaintiff-occupant requested a new trial on the basis of inadequate damages. When the second trial resulted in a jury verdict for the defendant, the plaintiff appealed, claiming that collateral estoppel should have prevented the defendant from relitigating the issue of liability. The court refused to

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[97]*See* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979); Eisel v. Columbia Packing Co., 181 F. Supp. 298 (D. Mass. 1960); Schwartz v. Public Adm'r, 24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 968 (1969).

[98]*Compare* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979), *with* Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir. 1964).

[99]*Compare* United States v. Utah Constr. & Mining Co., 384 U.S. 394 (1966), *with* North Carolina v. Chas. Pfizer & Co., 537 F.2d 67 (4th Cir. 1976).

[100]*See* Teitelbaum Furs, Inc. v. Dominion Ins. Co., 58 Cal. 2d 601, 375 P.2d 439, 25 Cal. Rptr. 559 (1962).

[101]*See* United States v. United Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962).

[102]*But see* Schwartz v. Public Adm'r, 24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 955 (1969) (offensive collateral estoppel applied despite inability of the defendant to assert counterclaim).

[103]*See* United States v. United Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962); Schwartz v. Public Adm'r, 24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 955 (1969).

[104]*Compare* United States v. United Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962), *with* Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir. 1964).

[105]*See* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979).

[106]*Id.* (4-day trial). *See also* United States v. United Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962) (15-day trial); Hart v. American Airlines, Inc., 61 Misc. 2d 41, 304 N.Y.S.2d 810 (Sup. Ct., Special Term 1969) (19-day trial).

[107]*Compare* Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir. 1964), *with* Schwartz v. Public Adm'r, 24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 955 (1969).

[108]*See* Taylor v. Hawkinson, 47 Cal. 2d 893, 306 P.2d 797 (1957).

[109]*See* Schwartz v. Public Adm'r, 24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 955 (1969); First Nat'l Bank v. Berkshire Life Ins. Co., 176 Ohio St. 395, 199 N.E.2d 86 (1964).

give estoppel effect to the prior judgment, which it found represented a compromise of liability and damages, reasoning: "Defendant did not have his day in court during the first trial on the issue of liability . . . . [A] judgment [is] binding upon him . . . only on the ground that he had an opportunity to attack it."[110] Compromise verdicts in nonmutuality provide an additional reason for denial: giving preclusive effect would enrich a nonparty plaintiff with "the benefit of full damages when no tribunal has ever made a proper finding of liability."[111]

Unlike compromise verdicts, jury trial availability is not widely regarded as an indicator of insufficient procedural opportunity. Authorities have disagreed on the fairness of estopping a party on issues triable to a jury in a second suit but decided previously by a judge. According to the *Restatement (Second) of Judgments*, the availability of a jury trial in the second action is a "fuller procedural opportunit[y]" which indicates that the original litigation was less than fair.[112]

The Supreme Court in *Parklane*, however, refused to construe a jury trial as a procedural advantage:

> It is true . . . that the petitioners in the present action would be entitled to a jury trial of the issues bearing on whether the proxy statement was materially false and misleading had the SEC action never been brought . . . . But the presence or absence of a jury as factfinder is basically neutral, quite unlike, for example, the necessity of defending the first lawsuit in an inconvenient forum.[113]

Thus, the *Parklane* decision prohibits federal courts from considering a jury trial as indicative of fairness. The conflicting views of the jury trial illustrate the unpredictability of the discretionary test of fairness.

Perhaps the Court in *Parklane* too quickly dismissed the procedural consequences of a jury trial. Arguably, a jury is not always a neutral factfinder but "sometimes act[s] capriciously in terms of its theoretical function."[114] Also, assuming that the Supreme Court considers compromise verdicts in its test of fairness, the Court takes a contradictory position by rejecting jury trial availability. On one hand, the Court acknowledges the caprice of jury trials—compromise verdicts—but on the other hand refuses to acknowledge

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[110]47 Cal. 2d at 897, 306 P.2d at 799.

[111]F. James, Civil Procedure § 11.31 (1965).

[112]Restatement (Second) of Judgments § 88, comment d (Tent. Draft No. 3, 1976).

[113]439 U.S. at 332 n.19.

[114]F. James, *supra* note 111, at 596.

that such caprice may be a procedural advantage—availability of a jury trial.

V. Additional Considerations in Offensive Nonmutuality

A. *Higher Risk of Unfairness*

As suggested by the *Parklane* opinion, fairness is evaluated by a more rigorous standard when collateral estoppel is asserted by a nonparty plaintiff than when asserted by a party or a nonparty defendant.[115] Additional factors must be weighed in cases of offensive nonmutuality because it carries a higher risk of unfairness than mutuality or defensive nonmutuality.

A plaintiff as instigator has inherent procedural advantages in any litigation. By the filing of the suit, a plaintiff chooses the shape of litigation, the forum, and the time of trial. A plaintiff also decides whether to join in identical litigation pending against the defendant. These advantages may cause disadvantages to the defendant, such as an inconvenient forum.

Additional disadvantages may result when nonparty plaintiffs are permitted to estop the defendant; thus, the chances of unfairness are increased in offensive nonmutuality. For example, the defendant may face massive damages in subsequent suits by unforeseeable plaintiffs after he loses the issue of liability in the first suit.[116] The defendant may be sued repeatedly by multiple plaintiffs who stay out of the original suit although joinder is possible.[117] Multiple suits by successive plaintiffs may expose the defendant to inconsistent verdicts.[118]

Fear of these inequitable situations has caused some courts to limit nonmutuality to use by nonparty defendants.[119] Jurisdictions granting estoppel to a nonparty plaintiff have done so only after a careful search for unfairness. The procedural opportunity test must be applied, with full consideration of the following factors unique to

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[115]*See* note 93 *supra* and accompanying text.

[116]*See* note 121 *infra*.

[117]*See* note 122 *infra*.

[118]*See* note 123 *infra*.

[119]*See* note 4 *supra* for a partial listing of cases which have adopted nonmutuality limited to defensive use. A similar limitation was formulated by Professor Currie. Currie, *supra* note 25. Rather than proposing a blanket prohibition against estoppel of defendants, Professor Currie suggested that collateral estoppel should not apply against a party who lacked "initiative," that is, whose opportunity to litigate was not "complete and unfettered" because the other party controlled the time and place of trial. *Id.* at 303. No court has accepted Professor Currie's suggestion, and the California Supreme Court has specifically rejected it. Teitelbaum Furs, Inc. v. Dominion Ins. Co., 58 Cal. 2d 601, 375 P.2d 439, 25 Cal. Rptr. 559 (1962).

estoppel of defendants: (1) Forum—the plaintiff may have chosen a forum which was inconvenient for the defendants; and (2) compromise verdicts—a verdict for the plaintiff may have represented a compromise between damages and liability.[120]

In addition to procedural opportunity, offensive nonmutuality demands consideration of the following factors of unfairness: Lack of incentive,[121] availability of joinder,[122] and inconsistent judgments.[123]

B. *Incentive*

Although a defendant may have received every procedural opportunity, he may not have been motivated under the circumstances to present a full defense.[124] When the liability is small, the defense tends to be less vigorous; giving subsequent effect to the resulting judgment seems unfair.

The *Parklane* opinion emphasized incentive in granting offensive nonmutuality; the Court in its decision relied upon a finding that the defendants "had every incentive to litigate the [prior] SEC lawsuit fully and vigorously."[125] Lack of incentive alone has been sufficient to justify denial of offensive nonmutuality.[126]

Incentive to litigate is intangible. Courts must look to tangible indicators such as the amount of damages,[127] the seriousness of

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[120]*See* notes 97 and 108 *supra* and accompanying text.

[121]*Compare* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979), *and* United States v. United Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962), *with* Berner v. British Commonwealth Pac. Airlines, Ltd., 346 F.2d 532 (2d Cir. 1965).

[122]Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979).

[123]*Compare id., and* Desmond v. Kramer, 96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967), *with* Reardon v. Allen, 88 N.J. Super. 560, 213 A.2d 26 (Super. Ct. Law Div. 1965).

[124]In denying offensive nonmutuality because minimal damages did not motivate the defendant sufficiently, the court in Berner v. British Commonwealth Pac. Airlines, Ltd., 346 F.2d 532 (2d Cir. 1965), implied that incentive is distinct from procedural opportunity: "[W]hile not necessarily suggesting that BCPA did not have a 'full and fair opportunity to litigate' in [the prior action], we think it would be unfair in this case to use [the prior] result to the disadvantage of BCPA." The Supreme Court in *Parklane*, however, seemed to confuse procedural opportunity with incentive by relying on the length of trial and the opportunity to call witnesses in its determination of incentive. 439 U.S. at 332 n.18. A defendant does not become motivated by the length of his trial or by the opportunity to call witnesses. However, the defendant may become motivated if the charges against him are serious and if he is aware of an action pending against him, other factors upon which the *Parklane* opinion relied in finding incentive. *Id.*

[125]439 U.S. at 332.

[126]*See, e.g.*, Berner v. British Commonwealth Pac. Airlines, Ltd., 346 F.2d 532 (2d Cir. 1965).

[127]*See* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979); Berner v. British Commonwealth Pac. Airlines, Ltd., 346 F.2d 532 (2d Cir. 1965); United States v. United

allegations,[128] and the foreseeability of future suits[129] to determine whether a defendant was motivated to defend vigorously.

1. Damages.—The amount of damages a defendant faces generally will affect the vigor of his defense. A defendant sued for $500 will put up less of a fight than one sued for $500,000. Minimal damages in the first suit may indicate that the defendant did not contest the issues fully, especially when damages sought in the second suit are disproportionately higher.

The decision in *Berner v. British Commonwealth Pacific Airlines, Ltd.*[130] exemplifies disproportionate damages justifying denial of offensive nonmutuality. The *Berner* litigation arose from a fatal airplane crash. The defendant airlines failed to appeal an adverse judgment of $35,000 awarded to the estate of a deceased passenger. The second plaintiff, seeking over $7,000,000, attempted to preclude the defendant on the issue of liability.

The Second Circuit denied estoppel because the defendant's failure to appeal proved that it had not been motivated to contest liability as vigorously in the first suit as it might have been if faced with the second suit's damages.[131] The court distinguished the grant of offensive nonmutuality in *United States v. United Air Lines, Inc.*[132] on the ground of incentive: "[I]n [that case] . . . the first judgment involved 24 of 31 pending actions; the gravity of the potential liability is shown by the fact that the ultimate judgments against the airline totalled $2,337,308. . . . Obviously, the airline would have exerted its full efforts with so much at stake."[133]

2. Seriousness of the Allegations.—When the plaintiff's complaint charges the defendant with serious wrongs, the defendant is prompted to litigate with vigor.[134] The *Parklane* decision is instructive on the meaning of seriousness. The defendant was charged with

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Air Lines, Inc., 216 F. Supp. 709 (E.D. Wash. 1962); McCourt v. Algiers, 4 Wis. 2d 607, 91 N.W.2d 194 (1956).

[128]*See* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979); Teitelbaum Furs, Inc. v. Dominion Ins. Co., 58 Cal. 2d 601, 375 P.2d 439, 25 Cal. Rptr. 559 (1962).

[129]*See* cases cited note 127 *supra. See also* Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir. 1964).

[130]346 F.2d 532 (2d Cir. 1965).

[131]*Id.* at 541-42.

[132]216 F. Supp. 709 (E.D. Wash. 1962).

[133]346 F.2d at 541. The conclusion the *Berner* court drew from *United Air Lines* parallels the reasoning used in the *United* opinion: the district court inferred from the large potential liability involved that the "parties were thus motivated to try the . . . case in a full and thorough manner." 216 F. Supp. at 730.

[134]Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979). *See also* Teitelbaum Furs, Inc. v. Dominion Ins. Co., 58 Cal. 2d 601, 375 P.2d 439, 25 Cal. Rptr. 559 (1962) (felony charge, serious enough to prompt vigorous litigation, estopped defendant in subsequent civil suit).

issuing a proxy statement that was "materially false and misleading."[135] The Court relied upon the "serious allegations made in the SEC's complaint"[136] in concluding that the defendant was sufficiently motivated to litigate the SEC lawsuit fully and vigorously.[137]

3. Foreseeability.—Litigants who anticipate future suits tend to litigate more vigorously to avoid losing an issue which they may later be precluded from relitigating. Defendants, powerless in the instigation of suits, may not foresee future suits by other plaintiffs. If subsequent suits are unforeseeable, a defendant may not be motivated to defend as vigorously;[138] therefore, most courts would deny estoppel. The court in *Evergreens v. Nunan*[139] described the consequences of estoppel in subsequent unforeseeable suits: "Defeat in one suit might entail results beyond all calculation by either party; a trivial controversy might bring utter disaster in its train. There is no reason for subjecting the loser to such extravagant hazards . . . ."[140]

The Court in *Parklane* held that the defendants had incentive "in light of . . . the foreseeability of subsequent private suits that *typically* follow a successful Government judgment . . . ."[141] A test of foreseeability may be inferred: future suits are foreseeable if they "typically" follow the original suit. Apparently, a defendant need not be subjectively aware of future litigation because foreseeability is measured by an external objective standard similar to the foreseeability standard in negligence law.[142] The defendants in *Parklane* were actually aware of the pending stockholder's suit,[143] which added weight but apparently was not crucial to the determination of incentive.[144]

A separate opinion in *Zdanok v. Glidden Co.*,[145] however, relied upon the defendant's actual awareness in concurring with the majority's grant of offensive nonmutuality.[146] The defendant in *Zdanok* was estopped from relitigating the interpretation of an employment

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[135] 439 U.S. at 324.

[136] *Id.* at 332.

[137] *Id.*

[138] Parklane Hosiery Co. v. Shore, 439 U.S. at 330.

[139] 141 F.2d 927 (2d Cir. 1944).

[140] *Id.* at 929.

[141] 439 U.S. at 332 (emphasis added). *See also* note 124 *supra.*

[142] *See* W. Prosser, Handbook of the Law of Torts § 43 (4th ed. 1971).

[143] 439 U.S. at 332 n.18.

[144] *Id.* The Court did not mention subjective awareness in the body of its opinion but added it in a footnote. *Id.*

[145] 327 F.2d 944 (2d Cir. 1964).

[146] *Id.* at 957 (Lumbard, C.J., concurring).

contract with a second group of employees who had filed suit before the first action began.[147]

Foreseeability appears to be presumed in the litigation of mass accidents, unlike most other cases of nonmutuality. Usually decisions allowing mass-accident plaintiffs to estop the common defendant do not mention whether the defendant could foresee the subsequent litigation.[148] This may be explained by application of the *Parklane* test: multiple suits typically follow mass accidents and are therefore foreseeable.

C. Joinder

1. The Joinder Limitation.—"Joinder" describes procedural methods of unifying claims or parties.[149] Defensive nonmutuality induces joinder by its application because a plaintiff threatened by future estoppel is motivated to join all of his defendants. Unlimited offensive nonmutuality, however, fails to induce joinder because it motivates plaintiffs to sue separately rather than jointly,[150] although joinder is possible in the following ways. The plaintiffs may join in one action if they raise a common question in asserting a right to relief arising out of the same transaction or occurrence.[151] A plaintiff may intervene in a pending action if his claim and the main claim have an issue in common.[152]

Recognizing that unlimited application of offensive nonmutuality fails to promote judicial economy,[153] the Supreme Court in *Parklane* proposed a limitation: if a nonparty plaintiff "could *easily* have joined" in the first action, then he is not later entitled to the benefit of the first judgment.[154] The Supreme Court appeared to pattern its approach after a provision of the *Restatement (Second) of Judgments* which denies estoppel if the party asserting it "*could* have effected joinder in the first action between himself and his present adversary."[155] This "joinder limitation" is further explained in the *Restatement* comments:

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[147]*Id.*

[148]*See* Maryland v. Capital Airlines, Inc., 267 F. Supp. 298 (D. Md. 1967); Desmond v. Kramer, 96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967); Hart v. American Airlines, Inc., 61 Misc. 2d 41, 304 N.Y.S.2d 810 (Sup. Ct., Special Term 1969).

[149]*See* FED. R. CIV. P. 18-25.

[150]*See* notes 76-81 *supra* and accompanying text.

[151]*See* note 80 *supra.*

[152]*Id.*

[153]Parklane Hosiery Co. v. Shore, 439 U.S. at 329.

[154]*Id.* at 331 (emphasis added).

[155]RESTATEMENT (SECOND) OF JUDGMENTS § 88(3) (Tent. Draft No. 2, 1975) (emphasis added), *cited in* 439 U.S. at 330 n.13.

> A person in such a position that he might *ordinarily* have been expected to join as plaintiff in the first action, but who did not do so, may be refused the benefits of "offensive" issue preclusion where the circumstances suggest that he wished to avail himself of the benefits of a favorable outcome without incurring the risk of an unfavorable one. Such a refusal may be appropriate where the person could *reasonably* have been expected to intervene in the prior action, and ordinarily is appropriate where he withdrew from an action to which he had been a party.[156]

2. The Limitation Applied.—The joinder rules of *Parklane* and the *Restatement* suggest a potential difference in application, in particular, in deciding under what circumstances a party has failed to join. Under the *Parklane* rule, a plaintiff has failed to join only when he could have *easily* joined.[157] The *Restatement* rule further expands denial for failure to join: a plaintiff has failed when he might *ordinarily* have joined.[158]

Arguably, the *Parklane* rule is too lenient in granting offensive nonmutuality, especially in view of the Supreme Court's application of the principle in *Parklane*. The stockholder in *Parklane* did not attempt to join in the initial action, but the Court nevertheless allowed collateral estoppel: "The application of offensive collateral estoppel will not here reward a private plaintiff who could have joined in the previous action, since the respondent *probably* could not have joined in the injunctive action brought by the SEC even had he so desired."[159] Thus, the Supreme Court did not require that the plaintiff even attempt to join because he "probably" could not have joined.

The *Parklane* rule appears to be of minimal value as a limitation upon offensive nonmutuality; defendants, who have the burden of proving that estoppel should not apply,[160] face difficulty in proving that a subsequent plaintiff could "easily" and "probably"[161] have joined in the first suit. The *Restatement* rule of joinder appears to be a more effective means of restricting unnecessary suits because plaintiffs will be denied the use of a judgment if they could have "reasonably" and "ordinarily" joined.[162]

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[156] RESTATEMENT (SECOND) OF JUDGMENTS § 88, comment e (emphasis added).

[157] *See* note 154 *supra* and accompanying text.

[158] *See* note 156 *supra* and accompanying text.

[159] 439 U.S. at 331-32 (emphasis added).

[160] *See* note 90 *supra* and accompanying text.

[161] *See* notes 154 & 159 *supra* and accompanying text.

[162] *See* note 156 *supra* and accompanying text.

3. The Benefits of the Joinder Limitation.—Denial of offensive nonmutuality for failure to join seems to induce joinder artificially in the same way that defensive nonmutuality naturally induces joinder. When offensive nonmutuality is denied, plaintiffs are motivated to consolidate their claims because waiting will not give them the benefit of estoppel. Furthermore, joining in the litigation may reduce individual litigation expenses when additional plaintiffs share costs. Plaintiffs, discouraged from a "wait and see" attitude, are induced to join.[163] By inducing joinder and thus avoiding subsequent litigation altogether, the joinder limitation appears to align offensive nonmutuality with the goal of judicial economy.[164]

The joinder rule is also useful in preventing any unfairness that may result from unlimited offensive nonmutuality. First, a defendant, fearing an unfavorable verdict that multiple plaintiffs could later use, may feel compelled in the first suit to make an unsatisfactory settlement which has no estoppel effect.[165] By limiting the multiplicity of plaintiffs, the joinder rule reduces, in turn, any compulsion to settle unsatisfactorily. Second, plaintiffs might be tempted to arrange the order of trials so that the plaintiff most appealing to a jury will try his case first.[166] The joinder rule discourages such collusion because subsequent plaintiffs who could have joined cannot use the original judgment. Third, a plaintiff should not be permitted to ignore the public interest in minimizing litigation by avoiding joinder and later use to his advantage the judgment of the suit he avoided joining.[167] Moreover, a plaintiff who could have joined cannot avoid meeting the defendant face-to-face through his unjustifiable refusal to join. If the plaintiff chose to join in the first suit, the defendant will confront the plaintiff on the merits of the litigation. If the plaintiff refuses to join and later sues, the defendant will also confront the plaintiff on the merits: the plaintiff is denied use of the first judgment and thus the issue will be relitigated.

4. Class Actions.—When plaintiffs are so numerous that joinder is impracticable, courts may allow the plaintiffs to be represented in a class action, provided the plaintiffs are similar-

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[163]*See* Semmel, *supra* note 15.

[164]A corollary to the denial of estoppel to plaintiffs who failed to join has been suggested: if a defendant refuses to consolidate pending suits, he cannot complain when he is later estopped because he is responsible for the nonconsolidation. Semmel, *supra* note 15, at 1471-79.

[165]*See* Note, *Res Judicata: The Shield Becomes a Sword, Prior Adjudication of Negligence Bars Relitigation of That Issue by Other Plaintiffs in Subsequent Actions Based on Same Accident*, 1964 DUKE L.J. 402.

[166]*See* Spettigue v. Mahoney, 8 Ariz. App. 281, 445 P.2d 557 (1968).

[167]RESTATEMENT (SECOND) OF JUDGMENTS § 88, comment e (Tent. Draft No. 3, 1976).

ly situated and a class action is a superior form to individual suits.[168] When a class action is instituted under Federal Rule of Civil Procedure 23(c)(2), plaintiffs within the class may choose to opt out or remain in the action.[169] All those who remain within the class are bound as parties by a favorable or unfavorable judgment.[170] Plaintiffs who opt out of the class action are not bound and presumably cannot benefit from the judgment.[171]

The *Restatement (Second) of Judgments* instructs that offensive nonmutuality should ordinarily be refused to a person who withdrew from a class action although his situation was substantially similar to other class members.[172] Denial of collateral estoppel to one who unjustifiably chose not to be a member of the class coincides with the joinder limitation. Allowing plaintiffs to opt out of a class action and later use its judgment would promote additional litigation similar to allowing estoppel to plaintiffs who unjustifiably refuse to join in an action. The reliance by a plaintiff on a judgment from which he chose to opt out would also be unfair to class members who had paid all of the court costs while the subsequent plaintiff had paid none.

D. *Inconsistent Judgments*

1. *Mass Accidents.*—Multiple litigation may subject a defendant to judgments that conflict on the issue of liability. The possibility of inconsistent judgments is best seen in the litigation of mass accidents—nearly every victim files a claim against the defendant on the identical issue of negligence. The claims are often adjudicated separately because the plaintiffs typically reside in diverse jurisdictions. Thus, the likelihood of inconsistent judgments is great.

Illustrative of mass accidents is Professor Currie's postulation of a train accident in which fifty passengers are injured.[173] The first twenty-five actions result in victories for the defendant, but the twenty-sixth is decided for the plaintiff. Should the remaining plaintiffs be allowed to use the favorable finding against the defendant? Due process prevents a defendant from using a favorable judgment against new plaintiffs who have not had a chance to litigate.[174] However, due process does not foreclose a nonparty plaintiff from

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[168] FED. R. CIV. P. 23.
[169] FED. R. CIV. P. 23(c)(2).
[170] FED. R. CIV. P. 23(c)(3).
[171] RESTATEMENT (SECOND) OF JUDGMENTS § 88, comment e (Tent. Draft No. 3, 1976).
[172] *Id.*
[173] Currie, *supra* note 26.
[174] *See* note 21 *supra* and accompanying text.

estopping a defendant who has had his day in court.[175] Thus, the remaining plaintiffs can use the aberrational twenty-sixth judgment under a limitless application of offensive nonmutuality.

2. Multiple Plaintiff Limitation.—California rejected multiple plaintiff estoppel in *Nevarov v. Caldwell.*[176] The plaintiffs, parents of an infant passenger, were denied use of the infant's judgment to establish the negligence of a common defendant. The court excluded "multiple claims of different persons for personal injuries or property damage against a single defendant or set of defendants growing out of a single accident"[177] from application of the *Bernhard* doctrine. The court in *Price v. Atchison, Topeka & Santa Fe Railway*[178] followed *Nevarov* in disallowing a nonparty passenger to estop a defendant railroad from relitigating negligence in a train derailment.[179]

3. Denial of Estoppel When Judgments Conflict.—The *Reardon v. Allen*[180] opinion implied that New Jersey also denied offensive estoppel to multiple plaintiffs.[181] The court in *Reardon* refused to allow a nonparty plaintiff to use a prior determination of negligence in an automobile collision because inconsistent judgments were possible.[182]

The same jurisdiction several years later in *Desmond v. Kramer*,[183] however, granted offensive nonmutuality to a bus passenger who had not been a party to the first suit in which fourteen other passengers won a favorable judgment.[184] The *Desmond* court decided that the defendants had a full and fair opportunity to litigate because the original suit approximated a class action, prior verdicts were not inconsistent, and the stakes were high.[185] The *Desmond* opinion instructed: "The problem of inconsistent verdicts can be avoided if, as a practical matter, a rule is adopted which would allow the application of *res judicata* only where there has been no actual inconsistency."[186] The finding of full and fair opportunity apparently accounted for the switch in viewpoints because such a finding seems to provide courts with "a means of overcoming their

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[175]*Id.*

[176]161 Cal. App. 2d 762, 327 P.2d 111 (1958).

[177]*Id.* at 778, 327 P.2d at 119.

[178]164 Cal. App. 2d 400, 330 P.2d 933 (1958).

[179]*Id.* at 403, 330 P.2d at 935.

[180]88 N.J. Super. 560, 213 A.2d 26 (Super. Ct. Law Div. 1965).

[181]*Id.*

[182]*Id.* at 573, 213 A.2d at 32-33.

[183]96 N.J. Super. 96, 232 A.2d 470 (Super. Ct. Law Div. 1967).

[184]*Id.*

[185]*Id.* at 108, 232 A.2d at 477.

[186]*Id.* at 104, 232 A.2d at 475.

reluctance to apply collateral estoppel in the multiple-claimant situation and their fear of irregular results which might occur."[187]

The Supreme Court in *Parklane* adopted a rule identical to that in *Desmond*: "Allowing offensive collateral estoppel may also be unfair to a defendant if the judgment relied upon as a basis for the estoppel is itself inconsistent with one or more previous judgments in favor of the defendant."[188] The original judgment of liability did not conflict with any prior judgments; thus, offensive estoppel was granted.[189]

Arguably, the inconsistent judgments rule relies too heavily upon the first decision as being correct. A judgment for the defendant in the first suit will prevent subsequent plaintiffs from using a later favorable judgment; thus, the defendant's liability will necessarily be relitigated in each subsequent suit. On the other hand, a judgment for the original plaintiff will preclude the defendant on the issue of liability in all subsequent suits; nonparty plaintiffs need only prove damages. Nevertheless, the inconsistent judgments restriction proves its worth in a sizable way: a defendant is forced to present only one very vigorous defense—in the first suit. If the defendant loses, he will be subsequently precluded from relitigating the issue. If the defendant wins, he may later defend in a normal manner because no fear of future issue preclusion will exist. Therefore, the defendant is relieved from having to defend each suit with full vigor as he would be forced to do if no restriction were placed on multiple plaintiff estoppel.

Another problem is avoided. If the last twenty-four plaintiffs in Professor Currie's example were allowed use of the favorable judgment, the first twenty-five "who emerged from court penniless . . . [would] now look on in horror as others suddenly collect handsome sums without effort . . . ."[190]

VI. Flaws in Nonmutuality Limited by Fairness

A. Shortcomings of the Unfairness Test

1. Insufficient Guideline.—The fairness limitation varies with each court and each case. A court within its discretion decides whether estoppel would be unfair under the circumstances. Replacing the rigid test of mutuality with the discretionary test of unfairness gives courts much leeway in defining what is "unfair."

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[187] 47 Neb. L. Rev. 640, 649 (1968).
[188] 439 U.S. at 330.
[189] *Id.* at 332-33.
[190] 43 Ind. L.J. 155, 160 (1967).

Judicial evaluation of jury trial availability[191] is but one illustration of conflicting notions of fairness. Consequently, the law of preclusion is unpredictable[192] although possibly "no greater than existed under the situation prior to *Bernhard* when the 'mutuality' rule was subject to unpredictable exceptions."[193] A litigant can never be certain of the future effects of a losing judgment because he cannot predict how the next court will judge fairness.

The problem of evaluating a nebulous concept such as fairness is compounded by the difficulty a second court faces in determining from lifeless transcripts the fairness of a case heard by another court. In this context, one authority has questioned: "How can a judge evaluate the vigor of litigation in a case in which he did not sit? How can he weigh the difficulty a defendant faced by being forced to litigate in one jurisdiction rather than another? How did the burden of proof or applicable presumptions affect the result?"[194]

The vagueness and difficulty of the unfairness test may provide courts with an insufficient guideline for proper decision-making. Consequently, the test may be misapplied to the detriment of the estopped party, as the following cases illustrate. The Supreme Court of Minnesota in *Lustik v. Rankila*[195] allowed issue preclusion against a defendant-turned-plaintiff on the issue of negligence decided adversely in the first suit although the original plaintiff had been afforded a presumption of due care.[196] The New York Supreme Court in *Schwartz v. Public Administrator*[197] permitted estoppel in a second action between former codefendants although the estopped party had been unable to interpose a counterclaim initially because of insurance policy regulations.[198] These examples reveal that the discretionary test of unfairness will not insure an accurate and predictable determination of fairness.

2. *Limited Consolidation of Parties.*—The modern doctrine of nonmutual collateral estoppel does not save subsequent litigation of issues but simply shifts it to heightened original litigation of issues and subsequent litigation of fairness;[199] however, any increase in litigation is offset by consolidation of suits induced naturally in

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[191]*See* notes 112-14 *supra* and accompanying text.

[192]Greenebaum, *In Defense of the Doctrine of Mutuality of Estoppel*, 45 IND. L.J. 1, 14 (1969).

[193]F. JAMES & G. HAZARD, *supra* note 1, § 11.25, at 584.

[194]Semmel, *supra* note 15, at 1469.

[195]269 Minn. 515, 131 N.W.2d 741 (1964).

[196]*Id.* at 518-19, 131 N.W.2d at 743-44.

[197]24 N.Y.2d 65, 246 N.E.2d 725, 298 N.Y.S.2d 955 (1969).

[198]*Id.* at 72-73, 246 N.E.2d at 730, 298 N.Y.S.2d at 964.

[199]*See* notes 60-75 *supra* and accompanying text.

defensive-use cases[200] and artificially through a joinder limitation in offensive-use cases.[201]

Procedural joinder is not totally effective in promoting consolidated suits. In cases of defensive nonmutuality, the plaintiff may be unable to find a forum in which to join all defendants because of jurisdictional barriers.[202] Faced with the possibility of future estoppel by defendants he cannot join, a plaintiff is forced to choose his first defendant carefully, selecting the defendant who might be the easiest to defeat.

Joinder in offensive nonmutuality may also be difficult to effect; thus, the joinder limitation may be of minimal value in encouraging plaintiffs to consolidate. Plaintiffs often reside in scattered jurisdictions and may choose to file separately rather than join in an inconvenient forum. When joinder is not "easy"[203] or "ordinary,"[204] the joinder rule will not deny estoppel and thus plaintiffs will not be induced to consolidate. Consequently, plaintiffs will not be discouraged from filing separately and may secretly arrange the order of suits to have the most sympathetic plaintiff file first.[205] Also, the defendant may still feel forced to settle to avoid future estoppel; he may be unable to discern, under present joinder standards, whether a plaintiff waiting to sue has failed to join and thus cannot use estoppel.[206]

If joinder is impracticable, plaintiffs may consolidate in a class action with permission of the court.[207] Class actions are rarely granted, however, particularly when the litigation involves a mass accident. The drafters of the 1966 amendments to the Federal Rules of Civil Procedure caution that a " 'mass accident' . . . is ordinarily not appropriate for a class action . . . ."[208] Class actions have seldom been permitted in mass accident cases; courts are reluctant to bind absent class members in personal injury suits.[209]

The Third Circuit in *Katz v. Carte Blanche Corp.*[210] seemed to undercut the effectiveness of class actions by suggesting that the availability of offensive collateral estoppel may negate the superiority of a class action to individual suits. At the defendant's request, the *Katz* court granted postponement of a class action until a "test

[200] *See* notes 76-77 *supra* and accompanying text.
[201] *See* note 163 *supra* and accompanying text.
[202] *See generally* F. JAMES & G. HAZARD, *supra* note 1, § 12.1-.30.
[203] *See* note 154 *supra* and accompanying text.
[204] *See* notes 155-56 *supra* and accompanying text.
[205] *See* note 166 *supra* and accompanying text.
[206] *See* note 165 *supra* and accompanying text.
[207] *See* notes 168-71 *supra* and accompanying text.
[208] FED. R. CIV. P. 23 (Notes of Advisory Committee on 1966 Amendment to Rules).
[209] *See* Note, *Mass Accident Class Actions*, 60 CALIF. L. REV. 1615 (1972).
[210] 496 F.2d 747 (3d Cir. 1974).

case" could decide liability because the defendant was willing to risk estoppel by the future class members if it should lose.[211] Although *postponement* of a class action may be justified under such circumstances, *denial* is not: denying class actions because offensive estoppel exists fosters successive litigation by plaintiffs instead of encouraging them to consolidate their claims.

In summary, consolidation of suits induced by nonmutuality is limited by current restrictions on joinder and class actions. In addition, the joinder limitation on offensive nonmutuality provides little guidance for determining whether a plaintiff has failed to join.[212]

3. Reliance on Incentive.—Offensive nonmutuality requires evaluation of the defendant's incentive to litigate, measured by the foreseeability of future suits[213] and the size of damages.[214] Reliance on these factors may unreasonably compel a vigorous defense.

Foreseeability in *Parklane* supported an inference of incentive, which, in turn, supported a finding of fairness.[215] By implication, when suits are foreseeable, estoppel may apply unless unfair for some other reason. Thus, a defendant is compelled to increase the vigor of his first defense if suits "typically follow"[216] the original suit because the defendant will not be given a second chance to litigate. To allocate adequate funds to the original defense of an issue, the defendant must estimate the worth of potential suits. Imposing a duty to foresee future suits and defend based on an estimation of their worth seems unjust:

> Defendants who have no claims of their own should be under no such procedural obligation. They are thrust into courts at the instance of claimants; they do not of their own motion impose upon the time of the courts. Once in court their only obligation should be to themselves—to defend the present claim as they see fit.[217]

The unfairness of forcing a defendant to defend with full vigor in the first action as if defending against all *future foreseeable* suits is magnified when original damages are minimal. A defendant with little at stake should not be compelled to intensify his defense to the utmost simply because he may foresee a larger claim that might never be filed. Such a result seems not only unjust to the defendant

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[211] *Id.*

[212] *See* notes 157-62 *supra* and accompanying text.

[213] *See* note 129 *supra* and accompanying text.

[214] *See* note 127 *supra* and accompanying text.

[215] 439 U.S. at 332.

[216] *Id.*

[217] Note, *The Impacts of Defensive and Offensive Assertion*, *supra* note 76, at 1055.

of a small suit, but also to the plaintiff who is suddenly faced with a vigorous defense on an issue he expected to dispose of in a brief trial.[218] Consequently, the plaintiff may be forced to give up his valid claim because further pursuit is no longer economically feasible.[219]

To force a vigorous defense merely because future suits are *possible* seems unreasonable. Only when suits are actually pending does the compulsion of a heightened defense seem fair.

B. *Inherent Unfairness in Nonmutuality*

Nonmutuality rests on the proposition that a person cannot relitigate after having his day in court, but this begs the question "a day in court against whom?"[220] A losing party has not had a day in court *against* the nonparty who estops him; thus, nonmutuality may inherently violate due process if "day in court" is defined as a private contest between parties.[221]

The history of the legal system supports this definition. The lawsuit evolved to protect society from the dangers of unrestricted disputes and still remains a kind of "sublimated, regulated brawl, a private battle conducted in a court-house."[222] The present adversary system is designed to allow opponents to meet in battle; nonmutuality conflicts with this system by allowing a competitor to be declared the loser to one he has never met on the field of contest.[223]

Courts make specific decisions in specific disputes. The Third Circuit described the lawsuit as "not a laboratory experiment for the discovery of physical laws of universal application but a means of settling a dispute between litigants."[224] Judgments are tailor-made to the parties they bind.[225] Thus, estoppel by a nonparty may give untoward effect to a judgment fashioned with a former litigant in mind.

Preclusion may be unfair for an additional reason: extraneous factors rather than the merits may decide a case.[226] An Arizona

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[218]Reardon v. Allen, 88 N.J. Super. 560, 572, 213 A.2d 26, 32 (Super. Ct. Law Div. 1965).

[219]Semmel, *supra* note 15, at 1465, 1469.

[220]1B MOORE'S, *supra* note 10, ¶ 0.412[1]. *But see* Israel v. Wood Dolson Co., 1 N.Y.2d 116, 134 N.E.2d 97, 151 N.Y.S.2d 1 (1956), in which it was stated: "[T]he fact that a party has not had his day in court on an issue *as against a particular litigant* is not decisive in determining whether the defense of *res judicata* is applicable." *Id.* at 119, 134 N.E.2d at 99, 151 N.Y.S.2d at 4.

[221]*See* J. FRANK, COURTS ON TRIAL 5-9 (1949).

[222]*Id.* at 7.

[223]Spettigue v. Mahoney, 8 Ariz. App. 281, 286, 445 P.2d 557, 562 (1968).

[224]Hornstein v. Kramer Bros. Freight Lines, Inc., 133 F.2d 143, 145 (3d Cir. 1943).

[225]*See* J. FRANK, *supra* note 221.

[226]*Id.*

court in *Spettigue v. Mahoney*[227] described how such factors may arbitrarily affect a judgment:

> The selection of the judge and jury, the choice of counsel, the availability of witnesses, the manner of the presentation of their testimony, the dynamics of the rapport between witnesses and fact-finder, and the personalities and appearances of the parties as they impress the fact-finder in various ways, are all matters that defy scientific analysis, are affected by fortuitous circumstances and variously determine the outcome of a contest conducted in the courts of this country.[228]

Courts have no way of ascertaining whether these elusive factors unfairly influenced the original judgment; consequently, a party may be estopped although the original judgment was arbitrary. Retention of mutuality would minimize the danger of estopping a party on an arbitrary judgment. A losing party prejudiced by such a judgment would suffer its harm only once—at the hands of the original adversary—and not subsequently at the hands of multiple nonparties.

Risk of arbitrary judgments has caused a supporter of mutuality to argue that a party should have as many trials as he has adversaries.[229] Each trial represents a mathematical probability of an accurate and fair judgment; nonmutual estoppel after the first trial diminishes the probability of a fair judgment that a party would have been afforded had he been allowed to relitigate with each adversary.

VII. Conclusion

Many jurisdictions have been swept into the tide of nonmutuality begun in California. Nonmutual estoppel of defendants, however, has gained slower acceptance than estoppel of plaintiffs because of the heightened risk of unfairness and increased litigation.

The Supreme Court in *Parklane* instructed federal courts to apply nonmutuality when it seems fair, whether asserted against a plaintiff or a defendant. Many state courts which have resisted offensive nonmutuality are likely to follow the federal lead.

With the safeguard of mutuality gone, however, courts should carefully consider the consequences of allowing nonparties to assert

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[227] 8 Ariz. App. 281, 445 P.2d 557 (1968).

[228] *Id.* at 286, 445 P.2d at 562.

[229] *See* Note, *A Probabilistic Analysis of the Doctrine of Mutuality of Collateral Estoppel*, 76 Mich. L. Rev. 612 (1978).

the doctrine. Collateral estoppel must be denied if the party to be estopped would somehow be prejudiced by its application. Courts have examined the procedural opportunity afforded in the first suit to insure that the party had actually had a chance to litigate the issue. The Supreme Court in *Parklane* suggested additional considerations when nonmutual estoppel is asserted against a defendant, namely, incentive, joinder, and inconsistent judgments.[230]

Although courts can readily discern the inconsistency of judgments, they are unable to judge procedural opportunity, incentive, and joinder with complete accuracy and certainty. Judgments may vary as the result of procedural factors as well as extraneous ones not subject to analysis. The motivation of a defendant eludes clear proof. Certainly, the grant of nonmutuality does occasionally work unfairly because the estopped party is unable to prove to the court's satisfaction that he lacked incentive or procedural opportunity.

Nonmutuality treats estopped defendants and estopped plaintiffs unequally. Defendants undoubtedly suffer greater hardship when estopped by nonparty plaintiffs than plaintiffs when estopped by nonparty defendants. If a plaintiff loses in the first suit, he is simply *denied* the relief he requested in the present and future suits. However, a defendant who loses in the first suit is *compelled* by a decision of liability to pay damages proven in all subsequent identical claims. A defendant's first judgment is similar to an "adverse in rem adjudication, with an invitation to the world to make the most of it."[231] A prudent plaintiff will search court records for an adverse judgment against the defendant to use the judgment to the plaintiff's own benefit in his claim. The estoppel effect can be avoided only if unfairness can be proven.

Products liability litigation serves as an example of the crushing burden a losing defendant bears. A manufacturer is sued by a plaintiff for injuries resulting from a faulty product. Countless buyers have purchased the same product. If the manufacturer is held liable, all buyers similarly injured may avail themselves of the judgment on the defect issue because estoppel is fair in light of the factors which courts consider to determine fairness. Given the large number of customers, similar future suits are foreseeable because they may "typically follow,"[232] the charge of products liability is serious enough to expect vigorous defense, and joinder of plaintiffs is impossible because claims arise separately at the time of each injury.

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[230]439 U.S. at 331-33.

[231]Moore & Currier, *supra* note 65, at 309.

[232]Parklane Hosiery Co. v. Shore, 439 U.S. at 332.

Thus, the defendant can be estopped ad infinitum by future users injured by the product.

Perhaps all nonmutuality runs too great a risk of unfairness because fairness cannot be unerringly determined. If fairness is the prime concern of courts, then requiring mutuality may be the best method of meeting this concern. Mutuality guarantees fairness to the party by restricting the effect of the judgment to parties with whom the original party has actually litigated. A nonparty who has not litigated has lost nothing when he is denied the use of a judgment for lack of mutuality.

The rise of jurisdictions adopting nonmutuality, however, indicates that today's crowded courts are willing to risk potential unfairness to minimize litigation. Such risk-taking is sanctioned by the Supreme Court; its *Parklane* opinion directs discretionary application of nonmutuality. The judicial trend to reject mutuality appears well underway, especially after *Parklane*. Offensive as well as defensive nonmutuality will certainly receive wider attention and, perhaps, acceptance in future decisions. Limiting nonmutuality to defensive use, however, seems altogether reasonable in light of the greater hardship a defendant suffers by offensive use. If a defensive limitation is unacceptable, courts at least should retain a distinction between offensive and defensive use. Offensive use is inherently more burdensome and should be applied with greater caution only after application of a strict test for unfairness.

JANET SCHMITT ELLIS

Book Review

Products Liability and the Reasonably Safe Product. By Alvin S. Weinstein,* Aaron D. Twerski,** Henry R. Piehler,*** and William A. Donaher.****

New York Chichester, Brisbane, Toronto: John Wiley & Sons, Inc., 1978. Pp. ix, 314. $15.00.

I. Thesis

To one uninitiated in the method and logic of the law, products liability may appear to be an area with a simple philosophy—compensate the innocent consumer for harm suffered as a result of defective products. The legal analysis, however, is much more intricate and less susceptible to facile generalization. To the manufacturing community, the legal maze of defect, causation, foreseeable harm, and other concepts must seem both frustrating and insidious.

Products Liability and the Reasonably Safe Product[1] initiates the manufacturing community[2] into the mysteries of products liability law and enables the manufacturer to develop a reasoned scheme of design, production, and marketing. A legal primer for the manufacturer and those involved in the distributive chain, the book discusses the fundamentals of products liability law which should be used as an aid in establishing price and quality control procedures or in making cost and quality tradeoffs in the production process. The book is not intended to address the technical considerations of

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*Professor of Mechanical Engineering and Public Affairs, Carnegie-Mellon University. Adjunct Professor of Law, Duquesne University School of Law.

**Associate Dean and Professor of Law, Hofstra University School of Law.

***Associate Professor of Metallurgy, Materials Science and Public Affairs, Carnegie-Mellon University. Adjunct Professor of Law, Duquesne University School of Law.

****Professor of Law, Duquesne University School of Law.

[1]A. Weinstein, A. Twerski, H. Piehler & W. Donaher, Products Liability and the Reasonably Safe Product (1978) [hereinafter cited as Products Liability]. *See also* Donaher, Piehler, Twerski & Weinstein, *The Technological Expert in Products Liability Litigation,* 52 Tex. L. Rev. 1303 (1974) (discussing the role of expert witnesses, advocating an increased use); Twerski, Weinstein, Donaher & Piehler, *The Use and Abuse of Warnings in Products Liability—Design Defect Litigation Comes of Age,* 61 Cornell L. Rev. 495 (1976) (discussing the interplay of warnings and defect standards) [hereinafter cited as Twerski, *The Use and Abuse*]; Weinstein, Twerski, Piehler & Donaher, *Product Liability: An Interaction of Law and Technology,* 12 Duquesne L. Rev. 425 (1974) (dealing with the fundamental concepts forming the basis of the reviewed book).

[2]"Manufacturing community" refers to the engineering, management, and marketing personnel who produce an item that is placed in the stream of commerce.

the practicing bar; instead, it is offered as an overview to those who desire background information.

The authors, members of the two disciplines most closely concerned with products liability—management and the law,[3] pool their resources to "analyz[e] the role of technology and its interface with the law."[4] Specifically, they seek "to examine whether the practice of products litigation [is] based on established legal principles and . . . technological reality as well."[5] With this two-fold purpose in mind, the authors examine the legal responsibilities of the manufacturing community. They conclude that legal practice should complement the decision-making process of engineering and designing products:

> When it comes to evaluating the design process for safety, ... *[t]he designer can plan for the total avoidance of liability.* A product will not be declared defective in design merely because it caused an injury. A court will evaluate design safety by testing the reasonableness of the trade-offs that went into making the final design decisions. It is here that the manufacturer must be sensitive to the weight the courts have placed on the various factors in the risk-utility balancing process.[6]

The authors premise this conclusion on the theory that courts generally apply a risk-benefit calculus in determining liability.[7] Although the risk-benefit analysis conforms neatly with marketing policy, the test possesses certain deficiencies in light of courtroom realities. Before discussing the relative strengths and deficiencies of the risk-utility approach, this Review will provide a brief synopsis of the book's contents.

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[3]Professors Weinstein and Piehler teach engineering and public affairs at Carnegie-Mellon University; Professors Donaher and Twerski are Professors of Law at Duquesne and Hofstra Law Schools, respectively.

[4]PRODUCTS LIABILITY, *supra* note 1, at vii.

[5]*Id.* at viii.

[6]*Id.* at 137 (emphasis added).

[7]*Id.* at 51, 137. The authors apply the seven factors recommended by Dean Wade to guide courts in determining liability. *See* Wade, *Strict Liability of Manufacturers*, 19 SW. L.J. 5, 17 (1965). These seven factors are:

(1) The usefulness and desirability of the product.
(2) The availability of other and safer products to meet the same needs.
(3) The likelihood of injury and its probable seriousness.
(4) The obviousness of danger.
(5) Common knowledge and normal public expectation of the danger.
(6) The avoidability of injury by care in use of the product (including the effect of the instructions or warnings).
(7) The ability to eliminate the danger without seriously impairing the usefulness of the product or making it unduly expensive.

PRODUCTS LIABILITY, *supra* note 1, at 47 (citing Wade, *supra*, at 17).

II. Synopsis

The authors begin their consideration of the value of applying legal principles to the design process with a brief discussion of the three basic theories of products liability: negligence, turning on the conduct of the defendant; strict liability and implied warranty, turning on product quality and contractual expectations; and express warranty and misrepresentation, turning on product performance vis-a-vis explicit representations.[8] Discussing the elements of a tort action, the authors observe that each theory of liability requires proof that the product was defective at the time it left the defendant's hands and that the defect caused the harm. In discussing the basic elements of a products liability claim, the issue of duty is explored and described as a shorthand determination of whether a manufacturer should be held responsible for his product's design. The authors conclude that the questions raised by a court in deciding whether a duty exists should be raised by the manufacturers during the design stage.[9]

Building upon this foundation, the authors discuss the meaning of product defectiveness by contrasting production defects with design flaws.[10] A production defect occurs when a particular product fails to conform with the manufacturer's standard product.[11] Defining a design defect is not so simple; generally, American courts have employed two tests in defining design defectiveness: (1) the consumer expectancy test, and (2) the unreasonably dangerous test.[12] In

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[8]Products Liability, *supra* note 1, at 5-16.

[9]*Id.* at 27.

[10]*Id.* at 28-32.

[11]*Id.* at 31. *See* Caterpillar Tractor Co. v. Beck, 593 P.2d 871, 880 (Alaska 1979).

[12]Products Liability, *supra* note 1, at 45-51. Because the book is addressed to the manufacturing community, the debate about which test, consumer expectancy or risk-benefit, is preferable only receives brief attention. To illustrate the debate, consider the divergent views of Professors Calabresi and Hubbard. Calabresi contends that strict liability should focus on who has the incentive to make a cost-benefit analysis of accident costs and prevention costs. Minimizing these two concepts is referred to as "optimal deterrence." Calabresi, *Optimal Deterrence and Accidents*, 84 Yale L.J. 656 (1975). Calabresi's conception of strict liability has, in his opinion, two advantages: (1) Because the incentives to reduce costs fall on the parties, as opposed to the "regulator," strict liability can cope with situations where the optimal deterrence is achieved through mutual balancing by producer and consumer, and (2) Because the incentives are on the parties, any error by the "regulator" is presumed not to be the fault of the parties, so no one bears more than a theoretical 50 percent chance of having an error saddled on him. *Id.* at 669-70.

In contradistinction is Professor Hubbard's theory that defects should be defined according to consumer expectations. Hubbard, *Reasonable Human Expectations: A Normative Model for Imposing Strict Liability for Defective Products*, 29 Mercer L. Rev. 465, 465 (1978). Due to the vagueness of such concepts as "efficiency," "cost," and "benefit," Hubbard contends that human expectations should prevail over efficiency. Id. at 468-70. According to Hubbard, a product is defective only when it violates those

applying a consumer expectancy test, a manufacturer is liable whenever consumer expectations are frustrated.[13] Expressing a preference for the risk-benefit analysis, the authors explain some of the limitations of the expectancy approach. First, the expectancy test prevents liability when the danger is obvious to the user, regardless of whether the product's risks exceed its utility.[14] By focusing on consumer expectations, courts often overlook the feasibility of alternative designs which have a bearing on the defectiveness of a design.[15] Additionally, the expectancy standard is an unsound method of determining liability when the person injured by the product is not the buyer or user.[16] For example, an injured bystander may not have any expectation about the safety of a product purchased or used by another person.[17] Even if the injured party is the con-

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expectations. Hubbard concedes that efficiency should resolve the issue of defectiveness when both or neither the buyer and seller have reasonable expectations. *Id.* at 477-78. *See* notes 35-39 *infra* and accompanying text.

The distinction between the consumer expectation theory of defectiveness and the unreasonably dangerous approach, however, may be insignificant. Recent commentaries demonstrate that these tests serve some of the same policies. For example, Professor Fischer, a proponent of the risk-benefit test, proposes a multiple factor test that considers consumer expectations as well as those of the manufacturer. Fischer, *Products Liability—The Meaning of Defect*, 39 Mo. L. Rev. 339, 359 (1974). By the same token, factor six of Professor Wade's seven factors deals with the product user's anticipation of danger. Wade, *supra* note 7, at 17. Similarly, proponents of the reasonable consumer expectation theory incorporate elements of the unreasonably dangerous test. Advocating a consumer expectancy test, Professor Shapo has compiled a list of thirteen considerations which include such risk-benefit factors as "implications of the proposed decision for public health and safety generally," "cost to the producer and other sellers of acquiring the relevant information," and "the likely effects on prices and quantities of goods sold." Shapo, *A Representational Theory of Consumer Protection: Doctrine, Function and Legal Liability for Product Disappointment*, 60 Va. L. Rev. 1109, 1370-71 (1974).

A unified view and the one most likely to represent the actual decision-making process is that consumer expectations are incorporated in a risk-balancing test. Some commentators like Professor Hubbard, however, would disavow any unification of the tests.

For an instructive discussion about the consumer expectancy and risk-utility standards, see Caterpillar Tractor Co. v. Beck, 593 P.2d 871 (Alaska 1979) (adopting both standards).

[13]*E.g.*, Muller & Co. v. Corley, 570 S.W.2d 140 (Tex. Civ. App. 1978); Vincer v. Esther Williams All-Aluminum Swimming Pool Co., 69 Wis. 2d 326, 230 N.W.2d 794 (1975). *See generally* Fischer, *supra* note 12, at 348-52; Montgomery & Owen, *Reflections of the Theory and Administration of Strict Tort Liability for Defective Products*, 27 S.C.L. Rev. 803 (1976).

[14]*See* Products Liability, *supra* note 1, at 45-46. *See also* Keeton, *Product Liability and the Meaning of Defect*, 5 St. Mary's L.J. 30, 35 (1973); Montgomery & Owen, *supra* note 13, at 823.

[15]Products Liability, *supra* note 1, at 46-47.

[16]Fischer, *supra* note 13, at 351; Montgomery & Owen, *supra* note 13, at 823.

[17]Montgomery & Owen, *supra* note 13, at 823 n.67. Use of the consumer expecta-

sumer, he may be unable to recover because he is an expert aware of the product's defectiveness.[18] Consequently, consumer expectations may vary on the basis of a consumer's particular knowledge about a product.

The unreasonably dangerous test overcomes the doctrinal deficiencies of the consumer expectation test by examining whether on balance the benefits of a particular design are greater than its risks.[19] Typically, courts applying this test consider the availability and feasibility of alternative designs, as well as the product's use, environment, and risks.[20] The authors, in fact, conclude that *reasonable* consumer expectations are usually determined by balancing risk and utility.[21] Realistically, a consumer expects that a product will be reasonably safe in terms of relative advantages and disadvantages.

The application of a risk-benefit test demonstrates the complementary relationship between warnings and design in producing a reasonably safe product. Obviously, warnings are an inexpensive means of eliminating certain risks because the burden of adding a warning is almost always less than the probability and gravity of harm for failing to warn of the danger.[22] Although warnings are a cheap alternative to product safety, the authors observe that a consumer cannot be expected to understand multiple and complex warnings, the effectiveness of which decreases inversely to increases in multiplicity and complexity.[23] Moreover, the authors discuss the impact that design modifications have on the desirability of warnings:

> A warning may or may not be sufficient, depending on the probability of reducing the risk and the feasibility of the design alternatives that would eliminate the risk or substantially diminish it. Courts sensitive to the very real limitations that affect warnings have indicated their concern that in some instances even the best of warnings may not shield the manufacturer from liability. The vehicle for this instruction to manufacturers has been the design issue.

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tion test in this instance would require the fiction of imputing an expectation to the bystander.

[18]Fischer, *supra* note 12, at 349-50.

[19]*See* Fischer, *supra* note 12, at 348-52; Montgomery & Owen, *supra* note 13, at 815-18. *See also* PRODUCTS LIABILITY, *supra* note 1, at 45-51.

[20]*See* Phillips v. Kimwood Machine Co., 269 Or. 485, 525 P.2d 1033 (1974); Wade, *supra* note 7, at 17.

[21]PRODUCTS LIABILITY, *supra* note 1, at 51.

[22]*Id.* at 62. *See generally* Twerski, *The Use and Abuse*, *supra* note 1.

[23]PRODUCTS LIABILITY, *supra* note 1, at 63; Twerski, *The Use and Abuse*, *supra* note 1, at 514-15.

> *The message to the manufacturing community is clear. The ultimate design of a product must take into account design alternatives together with warnings in deciding how best to reduce the risk of injury.*[24]

Once a defect has been proven, it becomes necessary to link the defect to the harm suffered by the plaintiff. Causation assumes three dimensions in products liability cases: technical causation, classical causation, and proximate cause.[25] Technical causation requires proof that the particular flaw caused the malfunction alleged. In contrast, classical causation requires proof that the same malfunction harmed the plaintiff. Proximate cause is a shorthand description for a court's policy of limiting or extending liability in a particular case. The authors contend that proximate cause should be determined on the basis of whether it is fair to impose liability on a manufacturer because of the risks created by a design defect.[26] They offer the unique suggestion that manufacturers may eliminate the causal link between their product and a victim's injury by stating the limits of a product's life.[27] The manufacturer's failure to specify a product life may be a self-inflicted wound because "the manufacturer's knowledge of product life could help resolve not only the question of how long a product should last but also that of what intervening causes could have contributed to the defect."[28]

The authors also discuss the types of plaintiff conduct, including misuse, assumption of the risk, and failure to inspect, that might reduce or eliminate the extent of a manufacturer's liability, depending on whether the state has a contributory fault or a comparative fault system of liability. Moreover, the book devotes a chapter to a discussion of the potential liabilities of every member of a product's distributive chain, from the producer to the retailer.

The authors summarize that the manufacturer should apply the same risk-benefit factors employed by the courts to the design process.[29] According to the authors, "acceptability" of a product's design should be measured by a risk-benefit calculus, which considers the product's use, potential hazards, and the practicality of safety features, design changes, and effective warnings.[30]

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[24]PRODUCTS LIABILITY, *supra* note 1, at 62 (emphasis added).
[25]*Id.* at 75-85.
[26]*Id.* at 84-85.
[27]*Id.* at 82.
[28]*Id.*
[29]*Id.* at 136-44.
[30]*Id.* *See also* note 7 *supra* and accompanying text.

III. Comment

Clearly, *Products Liability and the Reasonably Safe Product* is a valuable introduction to the legal principles and social policies used to assess the responsibilities and performance of the manufacturing community. The authors approach the subject matter from the viewpoint of the engineer or manufacturer. Their style of writing is well suited to the audience; simple and concise, the text is punctuated with the facts of cases that bring legal principle to life.

At times, however, detail seems to exceed the capabilities of the audience. For example, the authors' proposal of an increased role for the expert witness would seem more appropriate in a book dealing with evidence and trial technique. At other times, important considerations seem to be overlooked; for instance, the Consumer Product Safety Act is appended, yet there is virtually no discussion of its effects on the manufacturing community.

As discussed previously, the book's primary strength is its suggestion that the manufacturers apply the same risk-benefit factors in the design process that the courts use in evaluating design defects. The synthesis of legal practice and technological reality is intuitively sensible. The authors' adoption of the risk-benefit test as a guide to product design satisfies two objectives of tort law: risk spreading and deterrence.[31] Theoretically, the test places the burden on the party who is best prepared to bear the risks of accident and to pass the

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[31]*See* Fischer, *supra* note 12, at 359. Professor Fischer recently outlined how the various risk-benefit factors serve the objectives of risk spreading and safety incentive:

I. Risk Spreading
   A. From the point of view of consumer.
      1. Ability of consumer to bear loss.
      2. Feasibility and effectiveness of self-protective measures.
         a. Knowledge of risk.
         b. Ability to control danger.
         c. Feasibility of deciding against use of product.
   B. From point of view of manufacturer.
      1. Knowledge of risk.
      2. Accuracy of prediction of losses.
      3. Size of losses.
      4. Availability of insurance.
      5. Ability of manufacturer to self-insure.
      6. Effect of increased prices in industry.
      7. Public necessity for the product.
      8. Deterrent effect on the development of new products.
II. Safety Incentive
   A. Likelihood of future product improvement.
   B. Existence of additional precautions that can presently be taken.
   C. Availability of safer substitutes.

Id. at 359.

losses through as a cost of production.[32] Moreover, the test demonstrates the feasibility of adding safety devices to reduce the number and extent of injuries, thereby encouraging manufacturers to design safer products.[33] From the manufacturer's perspective, the risk-benefit factors can be incorporated into the design process to reduce or eliminate liability.[34]

Nevertheless, a manufacturer who bases product liability decision-making on the book may find himself inadequately insulated from potential liability. Some courts may favor a consumer expectancy test because it expresses a preference for humanism.[35] Professor Hubbard recently commented that the "law ought to be humanistic in the sense that liability for product-related injuries ought to be apportioned in accordance with reasonable human expectations."[36] Acknowledging a bias favoring individual rights, Hubbard stated that human expectations and individual rights should prevail even if the product's benefits outweigh its risks.[37] Such reasoning indicates that some courts will not immunize a manufacturer from liability when the design satisfies a risk-benefit analysis.

According to Hubbard, the consumer expectancy test has the added advantage of avoiding the ambiguity "concerning the relative weights of the various goals and the institutional process for balancing the goals."[38] The value of different risk-benefit factors may vary from jurisdiction to jurisdiction.[39] Such inconsistency eliminates the predictability and uniformity that a risk-balancing formula might provide.

Even if a risk-benefit calculus is employed, the courts may not apply the test rigidly because of policy reasons or miscalculation.[40]

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[32]*See* Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055 (1972); Fischer, *supra* note 12, at 359. *See also* Caterpillar Tractor Co. v. Beck, 593 P.2d 871 (Alaska 1979).

[33]*See* Fischer, *supra* note 12, at 359.

[34]PRODUCTS LIABILITY, *supra* note 1, at 140.

[35]*See* Hubbard, *supra* note 12, at 468-70; Klemme, *The Enterprise Liability Theory of Torts*, 47 U. COLO. L. REV. 153, 191 n.106 (1976).

[36]Hubbard, *supra* note 12, at 465.

[37]*Id.* at 469.

[38]*Id.* at 488.

[39]*See id.*

[40]The manufacturer, however, may benefit from judicial policy excusing manufacturer liability when the risks exceed the benefits. For example, some courts may not impose liability on unavoidably dangerous products if the dangerous propensities were not known at the time of the injury. *See* Montgomery & Owen, *supra* note 13, at 818 n.51. *But see* Calabresi & Hirschoff, *supra* note 32, at 1071. The manufacturer also may benefit from judicial or consumer miscalculation. A victim may not sue because he incorrectly perceives benefits as exceeding risks. Calabresi, *supra* note 12, at 658-59. A judicial error also may excuse liability if the court miscalculates risks and benefits. *Id.* at 658. Frequent errors of this type may discourage manufacturers from taking steps to reduce accidents.

The authors assume that courts generally will excuse liability at the point where the benefits exceed the risks.[41] Some courts, however, may not excuse liability, regardless of whether the benefits are greater than the costs.[42] A court may affix liability upon the manufacturer in any case where proximate cause exists because of "the manufacturer's superior position to recognize the risk of such injuries and then to insure against or make plans to absorb the costs of resulting losses."[43] Succinctly stated, a court may consider the manufacturer to be a better risk spreader than the victim. Moreover, liability may be shifted because the courts erred in calculating the advantages and disadvantages of a particular design.[44] Such an error may result in manufacturer liability, notwithstanding the cost effectiveness of a design.

In sum, the manufacturer and engineer should be warned that the authors' test does not insure against liability for defective design. Despite the practical value of applying the risk-benefit calculus, courts may apply the consumer expectancy standard because they prefer individual rights over efficiency. Assuming that courts adopt the risk-benefit test, manufacturers still may face liability because they are viewed as better risk spreaders or because of judicial miscalculation, regardless of whether the benefits exceed the risks. Notwithstanding these weaknesses in the authors' approach, the book provides a manufacturer with a practical guide for designing products free from the defects warranting liability.

R. MATTHEW NEFF

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[41]This is implicit in the authors' belief that by prebalancing, liability can be avoided because a reasonable balance of risk and utility has been achieved already.

[42]*See* Calabresi, *supra* note 12, at 658; Montgomery & Owen, *supra* note 13, at 818.

[43]*See* Montgomery & Owen, *supra* note 13, at 818-19 n.51.

[44]*See* Calabresi, *supra* note 12, at 658.